6-1-2014

AICPA audit and accounting manual as of June 1, 2014 : nonauthoritative technical practice aid

American Institute of Certified Public Accountants (AICPA)

Audit and Accounting Manual

ISBN 978-1-94023-599-8

AAMAAM14P

AICPA American Institute of CPAs®

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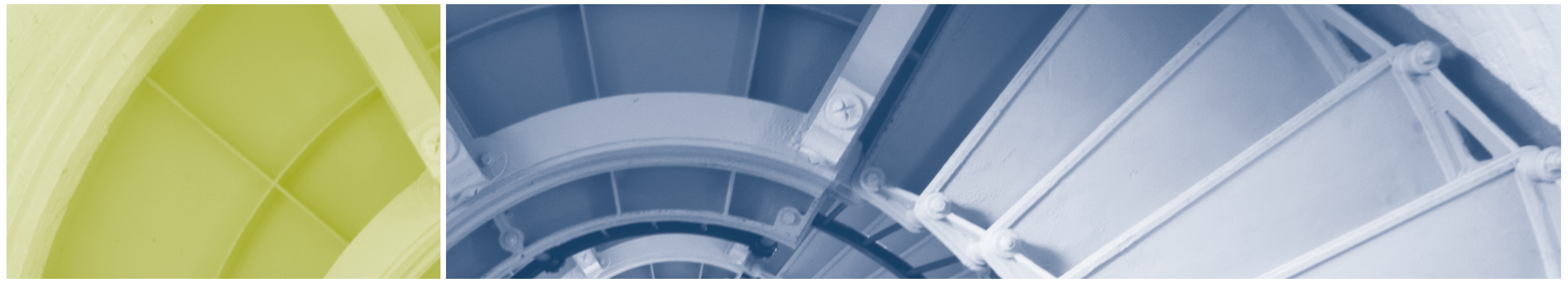
Audit and Accounting Manual

June 1, 2014

AICPA®



NONAUTHORITATIVE PRACTICE AID

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What's New in This Edition

The following sections of *Audit and Accounting Manual* have been updated for conforming changes as of June 1, 2014, due to the issuance of recent authoritative literature, including

- Statement on Auditing Standards No. 128, *Using the Work of Internal Auditors* (AICPA, *Professional Standards*, AU-C sec. 610).
- Interpretation No. 101-3, "Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05).
- Statement on Standards for Attestation Engagements No. 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence Is Impaired* (AICPA, *Professional Standards*, AT sec. 301 par. .23).
- QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*).

Section	Title
1000	Introduction
2000	How to Use the *Audit and Accounting Manual*
3000	Engagement Planning and Administration
4000	Internal Control
5000	Designing and Performing Further Audit Procedures
6000	Audit Documentation
7000	Correspondence, External Confirmations, and Written Representations

How to Use the *Audit and Accounting Manual* (Section 2000)

The title of section 2000 has been changed to *How to Use the* Audit and Accounting Manual, and former section 1200 has become section 2100. Former section 2000 has been deleted.

Alerts (Section 8000)

The following alerts have been updated.

Section	Title	Status
8012	General Accounting and Auditing Developments—2013/14	New Edition
8015	Compilation and Review Developments—2013/14	New Edition
8240	Independence and Ethics Developments—2014/15	New Edition

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How *Audit and Accounting Manual* is Organized

Scope of *Audit and Accounting Manual*

This publication brings together for continuing reference a set of nonauthoritative audit tools and illustrations prepared by the AICPA staff.

Arrangement of Material in *Audit and Accounting Manual*

The material in *Audit and Accounting Manual* is arranged as follows:

Introduction

Engagement Planning and Administration

Internal Control

Designing and Performing Further Audit Procedures

Audit Documentation

Correspondence, External Confirmations, and Written Representations

Alerts

Auditors' Reports

Quality Control

[*The next page is 1001.*]

AAM Section 1000
Introduction

The AICPA *Audit and Accounting Manual* has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the AICPA or FASB and has no official or authoritative status.

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AAM Section 1100

Introduction

.01 The *Audit and Accounting Manual* has been prepared by the staff of the AICPA and issued as a nonauthoritative practice aid. The materials included in it are intended primarily as a reference source for conducting audit engagements. The objective is to provide practitioners with the tools needed to help plan, perform, and report on their engagements. *The manual is not intended to serve as a complete or comprehensive quality control system.*

.02 The manual, where practicable, offers choices and alternatives rather than particular positions. The use of this or any other practice aid requires the exercise of individual professional judgment. The manual is not a substitute for the authoritative technical literature, and users are urged to refer directly to applicable authoritative pronouncements for the text of technical standards.

.03 This manual is intended to be used in connection with engagements of nonpublic entities and is not intended to be used in connection with audits of public entities that are required to be audited under standards set by the PCAOB.

.04 The authors hope that the manual will be helpful to practitioners in the conduct of their audit and accounting practice. However, no generalized material, such as that included in this manual, can be a substitute for the 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.

.05 The following table provides a summary of abbreviations used throughout the manual.

Explanation of References	
AT =	Reference to section number in AICPA *Professional Standards* for Statements on Standards for Attestation Engagements
AU-C =	Reference to section number in AICPA *Professional Standards* for Clarified Statements on Auditing Standards
AUD =	Reference to section number in the Auditing and Attestation Statements of Position in AICPA *Technical Practice Aids*
ET =	Reference to section number in AICPA *Professional Standards* for the Code of Professional Conduct, Interpretations of Rules of Conduct, and Ethics Rulings
FASB ASC =	Reference to the FASB *Accounting Standards Codification*®
GAAP =	Generally accepted accounting principles
QC =	Reference to section number in AICPA *Professional Standards* for Statements on Quality Control Standards
SAS =	AICPA Statement on Auditing Standards
SOP =	AICPA Auditing and Attestation Statement of Position
SQCS =	AICPA Statement on Quality Control Standards
SSAE =	AICPA Statement on Standards for Attestation Engagements
SSARS =	AICPA Statement on Standards for Accounting and Review Services

Guidance Considered in This Edition

.06 This edition of the manual has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the last edition of the manual, and other revisions as deemed appropriate. Authoritative guidance issued through June 1, 2014, has been considered in the development of this edition of the manual.

.07 Authoritative guidance that is issued and effective for entities with fiscal years ending on or before June 1, 2014, is incorporated directly in the text of this manual. The presentation of authoritative guidance issued but not yet effective as of June 1, 2014, for entities with fiscal years ending after that same date is being presented as a guidance update, which is a shaded area that contains information on the new guidance. The distinct presentation of this content is intended to aid the reader in differentiating content that may not be effective for the reader's purposes.

.08 This manual includes relevant guidance issued up to and including the following:

- SAS No. 128, *Using the Work of Internal Auditors* (AICPA, *Professional Standards*, AU-C sec. 610)
- Interpretation No. 1, "Communication of Significant Deficiencies and Material Weaknesses Prior to the Completion of the Compliance Audit for Participants in Office of Management and Budget Single Audit Pilot Project," of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, AU sec. 9265 par. .01–.03)
- Statement on Standards for Attestation Engagements (SSAE) No. 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence is Impaired* (AICPA, *Professional Standards*, AT sec. 301 par. .23)
- QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*)

Users of this manual should consider guidance issued subsequent to those items in the preceding list to determine its effect on entities covered by this manual. In determining the applicability of a pronouncement, its effective date should also be considered.

Defining Professional Responsibilities in AICPA Professional Standards

.09 AICPA *Professional Standards* applicable to audit engagements use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on auditors:

- *Unconditional requirements*. The auditor must comply with an unconditional requirement in all cases in which such requirement is relevant. Generally accepted auditing standards (GAAS) as issued by the Auditing Standards Board use the word *must* to indicate an unconditional requirement.
- *Presumptively mandatory requirements*. The auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances. GAAS use the word *should* to indicate a presumptively mandatory requirement.

.10 In rare circumstances, the auditor may judge it necessary to depart from a relevant presumptively mandatory requirement. In such circumstances, the auditor should perform alternative audit procedures to achieve the intent of that requirement. The need for the auditor to depart from a relevant presumptively mandatory requirement is expected to arise only when the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the intent of the requirement.

.11 Prior to SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification* (AICPA, *Professional Standards*), the terms *is required to* or *requires* were used to express an unconditional requirement in GAAS (equivalent to *must*). With the issuance of SAS No. 122, the terms *is required to* or *requires* do not convey a requirement or the degree of responsibility it imposes on auditors. Instead those terms are used to express that a requirement exists. The terms are typically used in the clarified auditing standards to indicate that a requirement exists elsewhere in GAAS.

.12 AICPA *Professional Standards* applicable to attest engagements use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on an auditor/accountant/practitioner [*as appropriate*]:

- *Unconditional requirements*. The auditor is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the requirement applies. The terms *must* and *is required* are used to indicate an unconditional requirement.
- *Presumptively mandatory requirements*. The auditor/accountant/practitioner [*as appropriate*] must comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the requirement applies; however, in rare circumstances the auditor/accountant/practitioner may depart from the requirement provided that the auditor/accountant/practitioner documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the requirement. The word *should* is used to indicate a presumptively mandatory requirement.

.13 It is important to note that upon the effective date of the clarified auditing standards the terms describing professional requirements for audit engagements is revised, and are therefore different than those used for attest engagements. See the preceding section for information on defining professional requirements related to auditing standards.

References to Professional Standards

.14 In citing GAAS and their related interpretations, references use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate. Similarly, when citing attestation standards, and their related interpretations, references use section numbers within the codification of currently effective SSAEs and not the original statement number, as appropriate.

FASB *Accounting Standards Codification*®

.15 The accounting guidance in this manual, where such guidance exists, has been conformed to reflect reference to FASB ASC as it existed on June 1, 2014 (through Accounting Standards Update No. 2014-08, *Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*).

AICPA.org Website

.16 The AICPA encourages you to visit the website at www.aicpa.org and the Financial Reporting Center at www.aicpa.org/FRC. The Financial Reporting Center was created to support members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process, and provides timely and relevant news, guidance and examples supporting the financial reporting process, including accounting, preparing financial statements and performing compilation, review, audit, attest, or assurance and advisory engagements. Certain content on the AICPA's websites referenced in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Manual

Auditing Standards Board's Clarity Project

.17 To address concerns over the clarity, length, and complexity of its standards, the Auditing Standards Board (ASB) redrafted its auditing standards for clarity and also converged the standards with the International Standards on Auditing (ISA), issued by the International Auditing and Assurance Standards Board. As a result of redrafting, the standards now specify more clearly the objectives of the auditor and the requirements with which the auditor has to comply when conducting an audit in accordance with GAAS.

.18 As part of the clarity project, the "AU-C" identifier was established to avoid confusion with references to existing AU sections. The "AU-C" identifier had been scheduled to revert back to the "AU" identifier at the end of 2013, by which time the previous AU sections would be superseded for all engagements. However, in response to user requests, the "AU-C" identifier will be retained indefinitely. The superseded AU sections were removed from *Professional Standards* at the end of 2013, as scheduled.

.19 The ASB has completed the Clarity Project with the issuance of SAS No. 128 in February 2014. SAS No. 128 is effective for audits of financial statements for periods ending on or after December 15, 2014. All other clarified auditing standards are now fully effective.

AICPA's Ethics Codification Project

.20 The AICPA's Professional Ethics Executive Committee (PEEC) restructured and codified the AICPA Code of Professional Conduct (code) so that members and other users of the code can apply the rules and reach appropriate conclusions more easily and intuitively. This is referred to as the AICPA Ethics Codification Project.

.21 Although PEEC believes it was able to maintain the substance of the existing AICPA ethics standards through this process and limited substantive changes to certain specific areas that were in need of revision, the numeric citations and titles of interpretations have all changed. In addition, the ethics rulings are no longer in a question and answer format but rather, have been drafted as interpretations, incorporated into interpretations as examples, or deleted where deemed appropriate. For example

- Rule 101, *Independence* [ET sec. 101 par. .01] is referred to as the "Independence Rule" [ET 1.200.001] in the revised code.
- the content from the ethics ruling titled "Financial Services Company Client has Custody of a Member's Assets" [ET sec. 191 par. .081–.082] is incorporated into the "Brokerage and Other Accounts" interpretation [ET 1.255.020] found under the subtopic "Depository, Brokerage, and Other Accounts" [ET 1.255] of the "Independence" topic [ET 1.200].

.22 The revised code is effective December 15, 2014 and is available at http://pub.aicpa.org/codeofconduct. References to the code in this manual will be updated in the next edition.

.23 To assist users in locating in the revised code content from the prior code, PEEC created a mapping document. The mapping document is available in Excel format at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/DownloadableDocuments/Mapping.xlsx and can also be found in appendix D in the revised code.

.24 See the preceding section titled "Guidance Considered in This Edition" for more information related to the guidance issued as of the date of this manual.

.25 This manual is expected to be updated periodically. Changes will likely arise from three main sources:

a. Comments and suggestions from practitioners. Because this manual is a product of AICPA staff and not of a committee of practitioners, it is particularly important that practitioners advise the staff on any suggestions for material that could be improved or added.

b. Issuance of authoritative guidance.

c. Other additions to or deletions from the manual as a result of continued staff study.

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AAM Section 2000
How to Use the *Audit and Accounting Manual*

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AAM Section 2100

How to Use the Audit and Accounting Manual

Overview

.01 The *Audit and Accounting Manual* is designed to provide practitioners with the tools needed to help plan, perform, and report on audit engagements. *This manual is not intended to serve as a complete or comprehensive quality control system, and it is not intended to be used in connection with the audits of entities that are required to be audited under standards set by the PCAOB.* This manual comprises the following sections.

Section No.	*Section Name*
1000	Introduction
2000	How to Use the Audit and Accounting Manual
3000	Engagement Planning and Administration
4000	Internal Control
5000	Designing and Performing Further Audit Procedures
6000	Audit Documentation
7000	Correspondence, External Confirmations, and Written Representations
8000	Alerts
9000	Auditors' Reports
10,000	Quality Control

Independence

.02 The auditor must be independent of the entity when performing an engagement in accordance with generally accepted auditing standards (GAAS) unless (*a*) GAAS provides otherwise or (*b*) the auditor is required by law or regulation to accept the engagement and report on the financial statements. When the auditor is not independent and neither (*a*) nor (*b*) are applicable, the auditor is precluded from issuing a report under GAAS.

Ethical Requirements Relating to an Audit of Financial Statements

.03 The auditor should comply with relevant ethical requirements relating to financial statement audit engagements.

.04 The auditor is subject to relevant ethical requirements relating to financial statement audit engagements. Ethical requirements consist of the AICPA Code of Professional Conduct together with rules of state boards of accountancy and applicable regulatory agencies that are more restrictive.

.05 The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include the following:

- Responsibilities
- The public interest
- Integrity
- Objectivity and independence

- Due care
- Scope and nature of services

.06 In the case of an audit engagement, it is in the public interest and, therefore, required by GAAS, that the auditor be independent of the entity subject to the audit. The concept of independence refers to both independence in fact and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective, and to maintain an attitude of professional skepticism. Independence implies an impartiality that recognizes an obligation to be fair not only to management and those charged with governance of an entity but also users of the financial statements who may rely upon the independent auditor's report. Guidance on threats to independence is set forth in the AICPA's *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*, ET sec. 100-1).

.07 When the auditor is not independent but is required by law or regulation to report on the financial statements, AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*), applies.

.08 Due care requires the auditor to discharge professional responsibilities with competence and to have the appropriate capabilities to perform the audit and enable an appropriate auditor's report to be issued.

.09 Paragraphs .21–.26 of QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), set out the firm's responsibilities to establish and maintain its system of quality control for audit engagements and to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence. Paragraphs .11–.13 of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), addresses the engagement partner's responsibilities regarding relevant ethical requirements. These include remaining alert for evidence of non-compliance with relevant ethical requirements by members of the engagement team, determining, in consultation with others in the firm as appropriate, the appropriate action if matters come to the engagement partner's attention, through the firm's system of quality control or otherwise, that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement. AU-C section 220 recognizes that the engagement team is entitled to rely on a firm's system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless the engagement partner determines that it is inappropriate to do so based on information provided by the firm or other parties.

.10 This manual will assist the auditor in performing an audit in accordance with GAAS in the following ways:

a. Section 3000, *Engagement Planning and Administration*, provides guidance in the planning stage. Included in this section are various formats of audit assignment controls and engagement letters.

b. Section 4000, *Internal Control*, conforms to *Internal Control—Integrated Framework,* published by the Committee of Sponsoring Organizations of the Treadway Commission, and AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). This section provides guidance on evaluating internal control by utilizing checklists, questionnaires, and other generalized aids.

c. Section 5000, *Designing and Performing Further Audit Procedures*, explains how the auditor should design and perform tests of controls, substantive procedures, or both, that are responsive to the assessed risks of material misstatement.

d. Section 6000, *Audit Documentation*, provides the auditor with a general discussion of the purpose of audit documentation.

e. Section 7000, *Correspondence, External Confirmations, and Written Representations*, provides the auditor with numerous examples of confirmations, illustrative inquiries to legal counsel, representation letters, communications with audit committees, and a reliance letter.

f. Section 9000, *Auditors' Reports*, addresses the format of the accountant's report and provides example auditor's reports.

g. Section 10,000, *Quality Control*, includes sample forms that can be used by a firm to document its adherence to the AICPA requirement for a system of quality control for a CPA firm.

Alerts

.11 Section 8000, *Alerts*, is intended to provide practitioners with an overview of recent economic, professional, and regulatory developments that may affect their engagements.

[*The next page is 3001.*]

AAM Section 3000
Engagement Planning and Administration

Sections 3160 and 3165 include illustrative audit assignment control forms and engagement letters that can be used by an accountant in the planning phase of an audit engagement.

Various formats of audit assignment controls and engagement letters are in use; nevertheless, inclusion of the formats in this section in no way means that they are preferable. Refer directly to authoritative pronouncements when appropriate.

Illustrative formats of audit assignment controls and engagement letters are often helpful in developing a consistent style within a firm. However, no set of illustrative formats can cover all the situations that are likely to be encountered in practice because the circumstances of engagements vary widely.

Readers should consider other sources of illustrative presentations, such as those in authoritative pronouncements and AICPA Audit and Accounting Guides.

References to Professional Standards. In citing generally accepted auditing standards and their related interpretations, references use section numbers within the codification of currently effective Statements on Auditing Standards and not the original statement number, as appropriate.

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AAM Section 3100

Understanding the Assignment

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 230, *Audit Documentation*
- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- AU-C section 300, *Planning an Audit*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 500, *Audit Evidence*
- AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
- AU-C section 550, *Related Parties*
- AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- AU-C section 610A, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*

ET Section:

- ET section 100-1, *Conceptual Framework for AICPA Independence Standards*

QC Section:

- QC section 10, *A Firm's System of Quality Control*

Introduction

.01 The auditor may (*a*) meet with the client to understand the type, scope, and timing of the engagement; (*b*) understand if reports on compliance, internal control, or segments of the entity are required; (*c*) understand the client's expectations, both stated and implied; and (*d*) review the expectations of both the owners and managers.

.02 To obtain an adequate understanding of any assignment, it is important for the auditor to understand accounting principles generally accepted in the United States of America (GAAP), which includes Emerging Issues Task Force (EITF) consensuses. It is also important that the auditor understand his or her overall responsibilities when conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS), which are promulgated by the AICPA and with which the auditor is required to comply. GAAS are developed and issued by the Auditing Standards Board (ASB) in the form of Statements on Auditing Standards (SASs) through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. When issued, SASs are codified into AU-C sections. GAAS are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

.03 GAAS do not address the responsibilities of the auditor that may exist in legislation, regulation, or otherwise, in connection with, for example, the offering of securities to the public. Such responsibilities may differ from those established in GAAS. Accordingly, although the auditor may find aspects of GAAS helpful in such circumstances, it is the responsibility of the auditor to ensure compliance with all relevant legal, regulatory, or professional obligations.

.04 AU-C section 200 establishes requirements and provides guidance regarding the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with GAAS. Specifically, AU-C section 200 establishes the overall objectives of the independent auditor (the auditor) and explains the nature and scope of an audit designed to enable the auditor to meet those objectives. It also explains the scope, authority, and structure of GAAS and includes requirements establishing the general responsibilities of the auditor applicable in all audits, including the obligation to comply with GAAS.

Association With Financial Statements

.05 An auditor is associated with financial information when the auditor has applied procedures sufficient to permit the auditor to report in accordance with GAAS. Statements on Standards for Accounting and Review Services address the accountant's considerations when the accountant prepares and presents financial statements to the entity or to third parties.

An Audit of Financial Statements

.06 The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework, which enhances the degree of confidence that intended users can place in the financial statements. An audit conducted in accordance with GAAS and relevant ethical requirements enables the auditor to form that opinion.

.07 The financial statements subject to audit are those of the entity, as prepared and presented by management of the entity with oversight from those charged with governance. GAAS do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with GAAS is conducted on the premise that management and, when appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

.08 As the basis for the auditor's opinion, GAAS require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. Reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit that result in most of the audit evidence, on which the auditor draws conclusions and bases the auditor's opinion, being persuasive rather than conclusive.

.09 The concept of materiality is applied by the auditor when both planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and uncorrected misstatements, if any, on the financial statements. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users that are taken based on the financial statements. Judgments about materiality are made in light of surrounding circumstances, and involve both qualitative and quantitative considerations. These judgments are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or both. The auditor's opinion addresses the financial statements as a whole. Therefore, the auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by fraud or error, that are not material to the financial statements as a whole, are detected.

.10 GAAS contain objectives, requirements, and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. GAAS require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things,

- identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- form an opinion on the financial statements, or determine that an opinion cannot be formed, based on an evaluation of the audit evidence obtained.

.11 The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable law or regulation.

.12 The auditor also may have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, regarding matters arising from the audit. These responsibilities may be established by GAAS or by applicable law or regulation.

Financial Accounting Standards Board *Accounting Standards Codification®*

Overview

.13 FASB *Accounting Standards Codification* (ASC) is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative GAAP by topically organizing the authoritative literature. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the EITF, and the AICPA) to organize them under approximately 90 topics.

.14 FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance. Moreover, FASB ASC does not include governmental accounting standards.

.15 FASB published a notice to constituents that explains the scope, structure, and usage of consistent terminology of FASB ASC. Constituents are encouraged to read this notice to constituents because it answers many common questions about FASB ASC. FASB ASC, and its related notice to constituents, can be accessed at http://asc.fasb.org/home and are also offered by certain third party licensees, including the AICPA. FASB ASC is offered by FASB at no charge in a Basic View and for an annual fee in a Professional View.

Issuance of Amendments to FASB ASC

.16 Amendments to FASB ASC are now issued through Accounting Standards Updates (ASUs) and serve only to update FASB ASC. FASB does not consider the ASUs authoritative in their own right; such amendments become authoritative when they are incorporated into FASB ASC.

.17 The ASUs issued are in the form of ASU No. 20YY-XX, in which "YY" is the last two digits of the year and "XX" is the sequential number for each update. For example, ASU No. 2012-01 is the first update in the calendar year 2012. The ASUs include the amendments to the codification and an appendix of FASB ASC update instructions. ASUs also provide background information about the amendments and explain the basis for the board's decisions.

.18 Amendments to FASB ASC issued in the form of ASUs (or other authoritative accounting guidance issued prior to the release date of FASB ASC) that are not fully effective, or became effective within that last six months, for all entities or transactions within its scope are reflected as "Pending Content" in FASB ASC. This pending content is shown in text boxes below the paragraphs being amended in FASB ASC and includes links to the transition information. The pending content boxes are meant to provide users with information about how a paragraph will change when new guidance becomes authoritative. When an amended paragraph has been fully effective for six months, the outdated guidance will be removed, and the amended paragraph will remain without the pending content box. FASB will keep any outdated guidance in the applicable archive section of FASB ASC for historical purposes.

.19 Because not all entities have the same fiscal year-ends and certain guidance may be effective on different dates for public and nonpublic entities, the pending content will apply to different entities at different times. As such, pending content will remain in place within FASB ASC until the *roll-off* date. Generally, the *roll-off* date is six months following the latest fiscal year end for which the original guidance being amended or superseded by the pending content could be applied as specified by the transition guidance. For example, assume an ASU has an effective date for fiscal years beginning after November 15, 2012. The latest possible fiscal year end of an entity still eligible to apply the original guidance being amended or superseded by the pending content would begin November 15, 2012, and end November 14, 2013. Accordingly, the *roll-off* date would be May 14, 2014.

.20 Entities cannot disregard the pending content boxes in FASB ASC. Instead, all entities must review the transition guidance to determine when the pending content is applicable to them.

Overall Objectives of the Auditor

.21 The overall objectives of the auditor, in conducting an audit of financial statements, are to

a. obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and

b. report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

.22 In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, GAAS require that the auditor disclaim an opinion or withdraw from the engagement, when withdrawal is possible under applicable law or regulation.

Auditor Requirements

Ethical Requirements Relating to an Audit of Financial Statements

.23 The auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (*a*) GAAS provides otherwise or (*b*) the auditor is required by law or regulation to accept the engagement and report on the financial statements. When the auditor is not independent and neither (*a*) nor (*b*) are applicable, the auditor is precluded from issuing a report under GAAS.

.24 The auditor should comply with relevant ethical requirements relating to financial statement audit engagements. Ethical requirements consist of the AICPA Code of Professional Conduct together with rules of state boards of accountancy and applicable regulatory agencies that are more restrictive.

.25 Because an audit engagement is in the public interest, AU-C section 200 requires that the auditor be independent of the entity subject to the audit. The concept of independence refers to both independence in fact and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective, and to maintain an attitude of professional skepticism. Independence implies an impartiality that recognizes an obligation to be fair not only to management and those charged with governance of an entity but also users of the financial statements who may rely upon the independent auditor's report. Guidance on threats to independence is set forth in ET section 100-1.

.26 Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct requires an AICPA member who performs an audit (the auditor) to comply with standards promulgated by bodies designated by Council, which includes the ASB. Section 3115, "Independence," in this manual provides additional discussion on maintaining independence.

.27 QC section 10 sets out the firm's responsibilities to establish and maintain its system of quality control for audit engagements, and to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence. AU-C section 220 addresses the engagement partner's responsibilities regarding relevant ethical requirements. These include remaining alert for evidence of non-compliance with relevant ethical requirements by members of the engagement team, determining, in consultation with others in the firm as appropriate, the appropriate action if matters come to the engagement partner's attention, through the firm's system of quality control or otherwise, that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement. AU-C section 220 recognizes that the engagement team is entitled to rely on a firm's system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless the engagement partner determines that it is inappropriate to do so based on information provided by the firm or other parties.

.28 Additional discussion on a firm's system of quality control can be found in section 10,000, "Quality Control," of this manual, including illustrative quality control forms and a reprint of the AICPA Practice Aid *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

Professional Skepticism

.29 The auditor should plan and perform an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated.

.30 Professional skepticism includes being alert to the following, for example,

- audit evidence that contradicts other audit evidence obtained.
- information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- conditions that may indicate possible fraud.
- circumstances that suggest the need for audit procedures in addition to those required by GAAS.

.31 Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of

- overlooking unusual circumstances.
- over-generalizing when drawing conclusions from audit observations.

- using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

.32 Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in light of the circumstances; for example, in the case when fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

.33 The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), GAAS require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

.34 The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

Professional Judgment

.35 The auditor should also exercise professional judgment in planning and performing an audit of financial statements.

.36 Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and GAAS and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. In particular, professional judgment is necessary regarding decisions about the following:

- Materiality and audit risk
- The nature, timing, and extent of audit procedures used to meet the requirements of GAAS and gather audit evidence
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of GAAS and thereby, the overall objectives of the auditor
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework
- The drawing of conclusions based on the audit evidence obtained; for example, assessing the reasonableness of the estimates made by management in preparing the financial statements

.37 The distinguishing feature of professional judgment expected of an auditor is that such judgment is exercised based on competencies necessary to achieve reasonable judgments, developed by the auditor through relevant training, knowledge, and experience.

.38 The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as those required by AU-C section 220, assists the auditor in making informed and reasonable judgments.

.39 Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing standards and accounting principles and is appropriate in light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

.40 Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant findings or issues arising during the audit. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or by sufficient appropriate audit evidence.

Sufficient Appropriate Audit Evidence and Audit Risk

.41 To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

Sufficiency and Appropriateness of Audit Evidence

.42 Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by a specialist employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and, therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

.43 The sufficiency and appropriateness of audit evidence are interrelated. *Sufficiency* is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

.44 *Appropriateness* is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

.45 Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby to enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. AU-C section 500 and other relevant AU-C sections, establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

Audit Risk

.46 Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

.47 For purposes of GAAS, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks, such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Risks of Material Misstatement

.48 The *risk of material misstatement* is the risk that the financial statements are materially misstated prior to the audit.

.49 The risks of material misstatement exist at two levels:

- The overall financial statement level
- The assertion level for classes of transactions, account balances, and disclosures

.50 Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

.51 Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

.52 The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

Inherent Risk

.53 *Inherent risk* is the susceptibility of a relevant assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

.54 Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

Control Risk

.55 *Control risk* is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

.56 Control risk is a function of the effectiveness of the design, implementation, and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation and fair presentation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. GAAS provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures to be performed. GAAS do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in nonquantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

.57 AU-C section 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

Detection Risk

.58 *Detection risk* is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

.59 For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

.60 Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. The following matters assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results:

- Adequate planning
- Proper assignment of personnel to the engagement team
- The application of professional skepticism
- Supervision and review of the audit work performed

.61 AU-C sections 300 and 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

Inherent Limitations of an Audit

.62 The auditor is not expected to, and cannot, reduce audit risk to zero and cannot, therefore, obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because inherent limitations of an audit exist, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The principal inherent limitations of an audit arise from

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

The Nature of Financial Reporting

.63 The preparation and fair presentation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and a range exists of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability that cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates that are dependent on predictions of future events. Nevertheless, GAAS require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and to related disclosures, and to the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

The Nature of Audit Procedures

.64 There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and fair presentation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation that may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Timeliness of Financial Reporting and the Balance Between Benefit and Cost

.65 The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognized in certain financial reporting frameworks (see, for example, FASB's Statements of Financial Accounting Concepts). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and so as to achieve a balance between benefit and cost, recognizing that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is fraudulent or erroneous until proved otherwise.

.66 Consequently, it is necessary for the auditor to

- plan the audit so that it will be performed in an effective manner;
- direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- use testing and other means of examining populations for misstatements.

.67 In light of the approaches described in paragraph .A53 of AU-C section 200 (discussed in the preceding paragraph), GAAS contain requirements for the planning and performance of the audit and requires the auditor, among other things, to

- have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities; and
- use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.

Other Matters That Affect the Inherent Limitations of an Audit

.68 In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include the following:

- Fraud, particularly fraud involving senior management or collusion. AU-C section 240 establishes requirements and provides guidance regarding the auditor's responsibility to consider fraud in a financial statement audit.
- The existence and completeness of related party relationships and transactions. AU-C section 550 establishes requirements and provides guidance regarding the auditor's responsibility to consider related party relationships and transactions in a financial statement audit.
- The occurrence of non-compliance with laws and regulations. AU-C section 250 establishes requirements and provides guidance regarding the auditor's responsibility to consider laws and regulations in a financial statement audit.
- Future events or conditions that may cause an entity to cease to continue as a going concern. AU-C section 570 establishes requirements and provides guidance regarding the auditor's responsibility in a financial statement audit to evaluate an entity's ability to continue as a going concern.

Relevant AU-C sections identify specific audit procedures to assist in lessening the effect of the inherent limitations.

.69 Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with GAAS. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less than persuasive audit evidence. Whether the auditor has performed an audit in accordance with GAAS is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof, and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

Conduct of an Audit in Accordance With GAAS

Complying With AU-C Sections Relevant to the Audit

Nature of GAAS

.70 The auditor should comply with all AU-C sections relevant to the audit. An AU-C section is relevant to the audit when the AU-C section is in effect and the circumstances addressed by the AU-C section exist.

.71 GAAS provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. GAAS address the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics. The scope, effective date, and any specific limitation of the applicability of a specific AU-C section are made clear in the AU-C section.

.72 In certain audit engagements, the auditor also may be required to comply with other auditing requirements in addition to GAAS. GAAS do not override law or regulation that governs an audit of financial statements. In the event that such law or regulation differs from GAAS, an audit conducted only in accordance with law or regulation will not necessarily comply with GAAS.

.73 The auditor may also conduct the audit in accordance with both GAAS and

- auditing standards promulgated by the PCAOB,
- International Standards on Auditing,
- *Government Auditing Standards*, or
- auditing standards of a specific jurisdiction or country.

In such cases, in addition to complying with each of the AU-C sections relevant to the audit, it may be necessary for the auditor to perform additional audit procedures in order to comply with the other auditing standards.

.74 The auditor should have an understanding of the entire text of an AU-C section, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

Contents of GAAS

.75 In addition to objectives and requirements, an AU-C section contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the AU-C section and definitions. The entire text of an AU-C section, therefore, is relevant to an understanding of the objectives stated in an AU-C section and the proper application of the requirements of an AU-C section.

.76 When necessary, the application and other explanatory material provides further explanation of the requirements of an AU-C section and guidance for carrying them out. In particular, it may

- explain more precisely what a requirement means or is intended to cover.
- include examples of procedures that may be appropriate in the circumstances.

.77 Although such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section. The auditor is required by paragraph .21 of AU-C section 200 to understand the application and other explanatory material; how the auditor applies the guidance in the engagement depends on the exercise of professional judgment in the circumstances consistent with the objective of the AU-C section. The words *may*, *might*, and *could* are used to describe these actions and procedures. The application and other explanatory material may also provide background information on matters addressed in an AU-C section.

.78 Appendixes form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related AU-C section or within the title and introduction of the appendix itself.

.79 Introductory material may include, as needed, such matters as explanation of the following:

- The purpose and scope of the AU-C section, including how the AU-C section relates to other AU-C sections
- The subject matter of the AU-C section
- The respective responsibilities of the auditor and others regarding the subject matter of the AU-C section
- The context in which the AU-C section is set

.80 An AU-C section may include, in a separate section under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of GAAS. These are provided to assist in the consistent application and interpretation of GAAS, and are not intended to override definitions that may be established for other purposes, whether in law, regulation, or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout GAAS.

.81 When appropriate, additional considerations specific to audits of smaller, less complex entities and governmental entities are included within the application and other explanatory material of an AU-C section. These additional considerations assist in the application of the requirements of GAAS in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of GAAS.

Considerations Specific to Audits of Smaller, Less Complex Entities

.82 For purposes of specifying additional considerations to audits of smaller, less complex entities, a *smaller, less complex entity* refers to an entity that typically possesses qualitative characteristics, such as

- concentration of ownership and management in a small number of individuals and
- one or more of the following:
  - — Straightforward or uncomplicated transactions
  - — Simple record keeping
  - — Few lines of business and few products within business lines
  - — Few internal controls
  - — Few levels of management with responsibility for a broad range of controls
  - — Few personnel, many having a wide range of duties

These qualitative characteristics are not exhaustive, they are not exclusive to smaller, less complex entities, and smaller, less complex entities do not necessarily display all of these characteristics.

.83 GAAS refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the *owner-manager*.

.84 The auditor should not represent compliance with GAAS in the auditor's report unless the auditor has complied with the requirements of AU-C section 200 and all other AU-C sections relevant to the audit.

Objectives Stated in Individual AU-C Sections

.85 To achieve the overall objectives of the auditor, the auditor should use the objectives stated in individual AU-C sections in planning and performing the audit considering the interrelationships within GAAS to

a. determine whether any audit procedures in addition to those required by individual AU-C sections are necessary in pursuance of the objectives stated in each AU-C section and

b. evaluate whether sufficient appropriate audit evidence has been obtained.

.86 Each AU-C section contains one or more objectives that provide a link between the requirements and the overall objectives of the auditor. The objectives in individual AU-C sections serve to focus the auditor on the desired outcome of the AU-C section, while being specific enough to assist the auditor in

- understanding what needs to be accomplished and, when necessary, the appropriate means of doing so; and
- deciding whether more needs to be done to achieve the objectives in the particular circumstances of the audit.

.87 Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph .12 of AU-C section 200. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

.88 In using the objectives, the auditor is required to consider the interrelationships among the AU-C sections. This is because, as indicated in paragraph .A58 of AU-C section 200, the AU-C sections in some cases address general responsibilities and in others address the application of those responsibilities to specific topics. For example, this section requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each AU-C section. At a more detailed level, AU-C section 315 and AU-C section 330 contain, among other things, objectives and requirements that address the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An AU-C section addressing specific aspects of the audit may expand on how the objectives and requirements of other AU-C sections are to be applied regarding the subject of that AU-C section, but does not repeat those objectives and requirements. For example, AU-C section 540 expands on how the objectives and requirements of AU-C section 315 and AU-C section 330 are to be applied regarding the subject of AU-C section 540, but AU-C section 540 does not repeat those objectives and requirements. Thus, in achieving the objective stated in AU-C section 540, the auditor considers the objectives and requirements of other relevant AU-C sections.

Use of Objectives to Determine Need for Additional Audit Procedures

.89 The requirements of GAAS are designed to enable the auditor to achieve the objectives specified in GAAS, and thereby the overall objectives of the auditor. The proper application of the requirements of GAAS by the auditor is therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in GAAS, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of GAAS and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by GAAS to meet the objectives specified in GAAS.

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained

.90 The auditor is required by paragraph .23*b* of AU-C section 200 to use the objectives stated in the relevant AU-C sections to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If, as a result, the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph .23*b* of AU-C section 200:

- Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other AU-C sections
- Extend the work performed in applying one or more requirements
- Perform other procedures judged by the auditor to be necessary in the circumstances

.91 When none of the preceding is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by GAAS to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

Complying With Relevant Requirements

.92 Subject to paragraph .26 of AU-C section 200, the auditor should comply with each requirement of an AU-C section unless, in the circumstances of the audit,

- the entire AU-C section is not relevant; or
- the requirement is not relevant because it is conditional and the condition does not exist.

.93 In some cases, an AU-C section (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in AU-C section 610A is relevant.

.94 Within a relevant AU-C section, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor's opinion if there is a limitation of scope represents an explicit conditional requirement.
- The requirement to communicate significant deficiencies and material weaknesses in internal control identified during the audit to management and those charged with governance, which depends on the existence and identification of such deficiencies, represents an implicit conditional requirement.

In some cases, a requirement may be expressed as being conditional on applicable law or regulation. For example, the auditor may be required to withdraw from the audit engagement, when withdrawal is possible under applicable law or regulation, or the auditor may be required to perform a certain action, unless prohibited by law or regulation. Depending on the jurisdiction, the legal or regulatory permission or prohibition may be explicit or implicit.

Defining Professional Responsibilities in GAAS

.95 GAAS use the following two categories of professional requirements, identified by specific terms, to describe the degree of responsibility it imposes on auditors:

- *Unconditional requirements*. The auditor must comply with an unconditional requirement in all cases in which such requirement is relevant. GAAS use the word *must* to indicate an unconditional requirement.
- *Presumptively mandatory requirements*. The auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances discussed in paragraph .26 of AU-C section 200. GAAS use the word *should* to indicate a presumptively mandatory requirement.

.96 In rare circumstances, the auditor may judge it necessary to depart from a relevant presumptively mandatory requirement. In such circumstances, the auditor should perform alternative audit procedures to achieve the intent of that requirement. The need for the auditor to depart from a relevant presumptively mandatory requirement is expected to arise only when the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the intent of the requirement.

Presumptively Mandatory Requirements

.97 If an AU-C section provides that a procedure or action is one that the auditor *should consider*, consideration of the procedure or action is presumptively required. Whether the auditor performs the procedure or action is based upon the outcome of the auditor's consideration and the auditor's professional judgment.

Departure From a Requirement

.98 AU-C section 230 establishes documentation requirements in those exceptional circumstances when the auditor departs from a relevant requirement. GAAS do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

Interpretive Publications

.99 Interpretive publications are not auditing standards. *Interpretive publications* are recommendations on the application of the GAAS in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with GAAS. Auditing interpretations of GAAS are included in AU-C sections. AICPA Audit and Accounting Guides and Auditing Statements of Position are listed in AU-C appendix D, *AICPA Audit and Accounting Guides and Statements of Position* (AICPA, *Professional Standards*).

.100 The auditor should consider interpretive publications in planning and performing the audit.

Other Auditing Publications

.101 In applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Although the auditor determines the relevance of these publications, the auditor may presume that other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are appropriate.

.102 In determining whether an other auditing publication that has not been reviewed by the AICPA Audit and Attest Standards staff is appropriate to the circumstances of the audit, the auditor may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying GAAS and the degree to which the issuer or author is recognized as an authority in auditing matters.

.103 *Other auditing publications* include, among other publications, the following:

- Auditing practice releases
- AICPA *Technical Practice Aids*—Technical Questions and Answers
- AICPA Audit Risk Alerts

Other auditing publications have no authoritative status; however, they may help the auditor understand and apply GAAS. The auditor is not expected to be aware of the full body of other auditing publications. Other auditing publications are listed in AU-C appendix F, *Other Auditing Publications* (AICPA, *Professional Standards*).

Failure to Achieve an Objective

.104 If an objective in a relevant AU-C section cannot be achieved, the auditor should evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with GAAS, to modify the auditor's opinion or withdraw from the engagement (when withdrawal is possible under applicable law or regulation). Failure to achieve an objective represents a significant finding or issue requiring documentation in accordance with AU-C section 230.

.105 Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes into account the results of audit procedures performed in complying with the requirements of GAAS, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in GAAS. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that

- prevent the auditor from complying with the relevant requirements of an AU-C section.
- result in it not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph .21; for example, due to a limitation in the available audit evidence.

.106 Audit documentation that meets the requirements of AU-C section 230 and the specific documentation requirements of other relevant AU-C sections provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. Although it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

[*The next page is 3121.*]

AAM Section 3105

Planning the Engagement

This section contains the following references from AICPA *Professional Standards*:

AU-C Section:

- AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
- AU-C section 210, *Terms of Engagement*
- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 260, *The Auditor's Communication With Those charged With Governance*
- AU-C section 300, *Planning an Audit*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*
- AU-C section 600, *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

ET Section:

- ET section 200, *General Standards*

Audit Planning

General

.01 The planning phase is an important part of every engagement. The objective of the planning phase is to plan the audit such that it will be performed in an effective manner.

.02 The need for planning is highlighted in Rule 201, *General Standards* (AICPA, *Professional Standards*, ET sec. 201 par. .01), of the AICPA Code of Professional Conduct, which states that a member shall adequately plan and supervise the performance of professional services.

.03 AU-C section 300 establishes standards and provides guidance regarding the independent auditor's responsibility to plan an audit of financial statements, including an initial audit engagement, in accordance with generally accepted auditing standards (GAAS).

.04 Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor identify and devote appropriate attention to important areas of the audit
- Helping the auditor identify and resolve potential problems on a timely basis

- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and allocating team member responsibilities
- Facilitating the direction and supervision of engagement team members and the review of their work
- Assisting, when applicable, in coordination of work done by auditors of components and specialists

.05 Proper planning also enhances the productivity of engagement personnel and may result in a more profitable engagement.

.06 The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team member's previous experience with the entity, and changes in circumstances that occur during the audit engagement.

.07 Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as the following:

- The analytical procedures to be applied as risk assessment procedures
- A general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework
- The determination of materiality
- The involvement of specialists
- The performance of other risk assessment procedures

.08 The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

.09 AU-C section 600 provides guidance that an auditor may find useful, adapted as necessary in the circumstances, when that auditor involves other auditors in the audit of financial statements that are not group financial statements. For example, an auditor may involve another auditor to observe the inventory count or inspect physical fixed assets at a remote location. Additional guidance regarding group audits can be found in Technical Questions and Answers sections 8800.01–.43 of section 8800, *Audits of Group Financial Statements and Work of Others* (AICPA, *Technical Practice Aids*).

Preliminary Engagement Activities

.10 The auditor should undertake the following activities at the beginning of the current audit engagement:

a. Performing procedures required by AU-C section 220 regarding the continuance of the client relationship and the specific audit engagement

b. Evaluating compliance with relevant ethical requirements in accordance with AU-C section 220

c. Establishing an understanding of the terms of the engagement as required by AU-C section 210

.11 Performing preliminary engagement activities at the beginning of the audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

.12 Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which

- the auditor maintains the necessary independence and ability to perform the engagement.
- the auditor has no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- the auditor has no misunderstanding with the entity about the terms of the engagement.

.13 The auditor's consideration of client continuance and relevant ethical requirements, including independence, occurs throughout the audit engagement as conditions and changes in circumstances occur. Performing initial procedures on both client continuance and evaluation of relevant ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often begin shortly after (or in connection with) the completion of the previous audit.

Terms of the Engagement

Preconditions for an Audit

.14 According to AU-C section 210, the objective of the auditor is to accept an audit engagement for a new or existing audit client only when the basis upon which it is to be performed has been agreed upon through

a. establishing whether the preconditions for an audit are present and

b. confirming that a common understanding of the terms of the audit engagement exists between the auditor and management and, when appropriate, those charged with governance.

.15 In order to establish whether the preconditions for an audit are present, the auditor should

- determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable and
- obtain the agreement of management that it acknowledges and understands its responsibility
    - for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework;
    - for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
    - to provide the auditor with
        - access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;
        - additional information that the auditor may request from management for the purpose of the audit; and
        - unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

.16 If the preconditions for an audit are not present, the auditor should discuss the matter with management. Unless the auditor is required by law or regulation to do so, the auditor should not accept the proposed audit engagement

- if the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or
- if the agreement referred to in paragraph .06*b* of AU-C section 210 has not been obtained.

.17 *Considerations specific to smaller, less complex entities*. One of the purposes of agreeing upon the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when the auditor or a third party has assisted with drafting the financial statements, it may be useful to remind management that the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

Agreement on Audit Engagement Terms

.18 The auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate. The roles of management and those charged with governance in agreeing upon the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation. Depending on the entity's structure, the agreement may be with management, those charged with governance, or both. When the agreement on the terms of engagement is only with those charged with governance, nonetheless in accordance with paragraph .06 of AU-C section 210, the auditor is required to obtain management's agreement that it acknowledges and understands its responsibilities. When a third party has contracted for the audit of the entity's financial statements, agreeing to the terms of the audit with management of the entity is necessary in order to establish that the preconditions for an audit are present.

.19 The agreed-upon terms of the audit engagement should be documented in an audit engagement letter or other suitable form of written agreement and should include the following:

a. The objective and scope of the audit of the financial statements

b. The responsibilities of the auditor

c. The responsibilities of management

d. A statement that because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with GAAS

e. Identification of the applicable financial reporting framework for the preparation of the financial statements

f. Reference to the expected form and content of any reports to be issued by the auditor and a statement that circumstances may arise in which a report may differ from its expected form and content

Form and Content of the Audit Engagement Letter

.20 The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on paragraphs .04–.10 of AU-C section 200. Paragraph .06*b* of AU-C section 210 addresses the description of the responsibilities of management. In addition to including the matters required by paragraph .10 of AU-C section 210, an audit engagement letter may make reference to, for example, the following:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, GAAS, and ethical and other pronouncements of professional bodies to which the auditor adheres
- The form of any other communication of results of the audit engagement

- Arrangements regarding the planning and performance of the audit, including the composition of the audit team
- The expectation that management will provide written representations (paragraph .A11 of AU-C section 210)
- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable
- The agreement of management to inform the auditor of events occurring or facts discovered subsequent to the date of the financial statements, of which management may become aware, that may affect the financial statements
- The basis on which fees are computed and any billing arrangements
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein, as may be evidenced by their signature on the engagement letter

.21 When relevant, the following points also could be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and specialists in some aspects of the audit
- Arrangements concerning the involvement of internal auditors and other staff of the entity
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit
- Any restriction of the auditor's liability when not prohibited
- Any obligations of the auditor to provide audit documentation to other parties
- Additional services to be provided, such as those relating to regulatory requirements
- A reference to any further agreements between the auditor and the entity

Additional Considerations

.22 The following matters may be considered while preparing an audit engagement letter:

- Whether circumstances preclude an unmodified opinion, as in these examples:
    - The auditor is retained after the beginning of the client's fiscal year, did not observe inventories or confirm receivables at the beginning of the year and was unable to gain satisfaction through application of alternative procedures.
    - The client imposes restrictions on the scope of the audit. (See AU-C section 705.)
    - Significant litigation or other matters exist which may affect the opinion.
- Whether the fee should be stated as a range, in hourly rates, as standard per diem charges for the engagement, or as a maximum or flat fee
- The person or persons to whom reports should be addressed
- The number of copies needed of the report and the people to whom they are to be distributed
- Deadlines for reports or analyses
- Timing of fieldwork
- Out-of-pocket costs
- The condition of records or circumstances other than those contemplated in the engagement letter (for example, deficient internal control)
- A retainer

- One time engagements
- Start-up costs when the client changes auditors
- Underwriters' requirements in connection with public offerings

.23 Often, entities that have never been audited resist signing a client representation letter. To avoid client resistance at the end of the audit, many firms notify the client in the audit engagement letter that they will be asked to sign a client representation letter.

.24 If the auditor has reason to believe the client may publish all or a portion of an audit report, he or she may advise the client (preferably in the audit engagement letter) that firm policy is to read printer's proofs of the report and any other accompanying material. This precaution protects both the client and the auditor against condensation of financial statements, omission of footnotes, erroneous layout, and other errors such as misstatement of figures used in a president's letter, other narrative, or statistics.

.25 It is considered best practice for the auditor to establish the understanding with the client and prepare the audit engagement letter before any significant work takes place on the engagement. The partner may personally present the letter to the client to ensure that a complete understanding has been achieved. The understanding or a signed copy of the audit engagement letter may be filed with the engagement's current working papers and permanent file.

Key Point

Be careful when using a proposal or preliminary audit 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. It is a best practice to always make sure that a final engagement letter is issued in such circumstances.

.26 The engagement letter is generally addressed to those charged with governance, the chief executive, or whoever retained the firm. If the engagement letter also serves as the method of communicating the auditor's responsibilities under AU-C section 260 the addressee should include those persons charged with governance. The engagement partner may sign the letter on behalf of the firm. The client representative responsible for the engagement signs the letter denoting agreement with the contract. The original letter may be maintained in the engagement documentation. A copy of the letter is given to the client.

.27 Following is a list of common engagement letter deficiencies:

- Reference in the letter to audit of the books and records rather than to audit of financial statements
- Adverse comments about other firms
- Failure to specify *in detail* the services to be rendered when a maximum fee is quoted
- Inclusion of a review of internal control as one of the services when what is really intended is an understanding of internal control as required by auditing standards
- Failure to identify accounting or other problems that may have an effect on the opinion
- Failure to change, in writing, the terms of the engagement when conditions are found to be different (such as the inability to express an opinion without extensive additional auditing because internal control was found to be deficient)
- Failure to include fee basis and payment terms
- Failure to identify subsidiaries
- Failure to identify specific tax returns to be prepared
- Failure to document the scope of the engagement

Fee Issues

.28 Two types of fee arrangements, contingent fees and commissions, are prohibited when the arrangement involves certain attest clients, even though the fee is not related to an attest service.

.29 A contingent fee is an arrangement whereby (*a*) no fee is charged unless a specified result is attained or (*b*) the amount of the fee otherwise depends on the results of your firm's services. Some examples of contingent fees are the following:

- Your firm receives a finder's fee for helping a client locate a buyer for one of the client's assets.
- Your firm performs a consulting engagement to decrease a client's operating costs. The fee is based on a percentage of the cost reduction that the client achieves as a result of your service.

.30 The following are exceptions:

- Fees fixed by a court or other public authority
- In tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies

.31 A commission is any compensation paid to you or your firm for (*a*) recommending or referring a third party's product or service to a client or (*b*) recommending or referring a client's product or service to a third party. Permitted commissions shall be disclosed to the person or entity you recommend or refer a product or service to.

.32 Examples of commissions are if you or your firm

- refers a client to a financial planning firm that pays you a commission for the referral.
- sells accounting software to a client and receives a percentage of the sales price (a commission) from a software company.
- refers a nonclient to an insurance company client, which pays you a percentage of any premiums subsequently received (a commission) from the nonclient.

.33 The AICPA rule provides an exception for *referral fees* for recommending or referring a CPA's services to another entity person or entity. That is, you may (*a*) receive a fee for referring the services of a CPA to any person or entity or (*b*) if you are a CPA, pay a fee to obtain a client provided you disclose such receipt or payment to the client. Referral fees are not considered commissions under these specific circumstances. You must inform the client if you receive or pay a referral fee.

.34 You and your firm may not have commission or contingent fee arrangements with a client when your firm also provides one of the following services to a client:

- An audit of financial statements
- A review of financial statements
- A compilation of financial statements when a third party (for example, a bank or investor) will rely on the financial statements and the report does not disclose a lack of independence
- An examination of prospective financial statements

.35 You and your firm may have commission and contingent fee arrangements with persons associated with a client—such as officers, directors, and principal shareholders—or with a benefit plan that is sponsored by a client (that is, the plan itself is not a client).[1] For example, you or your firm may receive a commission from a nonclient insurer if you refer an officer of an attest client to the insurer and the officer purchases a policy.

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[1] Also see AICPA Ethics Ruling No. 25, "Commission and Contingent Fee Arrangements With Nonattest Client," of ET section 391, *Ethics Rulings on Responsibilities to Clients* (AICPA, *Professional Standards*, ET sec. 391 par. .049–.050), of the AICPA Code of Professional Conduct.

Even when permitted, the existence of a commission arrangement must be disclosed to the person (or entity) to whom the commission relates.

Sample Engagement Letters

.36 See section 3165, "Sample Engagement Letter," for a sample engagement letter.

Acceptance of a Change in the Terms of the Audit Engagement

.37 The auditor should not agree to a change in the terms of the audit engagement when no reasonable justification for doing so exists. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement for which the auditor obtains a lower level of assurance, the auditor should determine whether reasonable justification for doing so exists. If the terms of the audit engagement are changed, the auditor and management should agree on and document the new terms of the engagement in an engagement letter or other suitable form of written agreement.

.38 If the auditor concludes that no reasonable justification for a change of the terms of the audit engagement exists and is not permitted by management to continue the original audit engagement, the auditor should

a. withdraw from the audit engagement when possible under applicable law or regulation,

b. communicate the circumstances to those charged with governance, and

c. determine whether any obligation, either legal, contractual, or otherwise, exists to report the circumstances to other parties, such as owners, or regulators.

Involvement of Key Engagement Team Members

.39 The engagement partner and other key members of the engagement team should be involved in planning the audit, including planning and participating in the discussion among engagement team members. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process. The engagement partner may delegate portions of the planning and supervision of the audit to other firm personnel.

Planning Activities

Forming an Audit Strategy

The Overall Audit Strategy

.40 The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and that guides the development of the audit plan. In establishing the overall audit strategy, the auditor should

a. identify the characteristics of the engagement that define its scope;

b. ascertain the reporting objectives of the engagement in order to plan the timing of the audit and the nature of the communications required;

c. consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

d. consider the results of preliminary engagement activities and, when applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

e. ascertain the nature, timing, and extent of resources necessary to perform the engagement.

.41 Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes but are closely interrelated because changes in one may result in consequential changes to the other.

.42 The appendix to AU-C section 300 provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters also will influence the auditor's detailed audit plan.

Considerations Specific to Smaller, Less Complex Entities

.43 In audits of smaller entities, the entire audit may be conducted by a very small audit team. Many audits of smaller entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, coordination of, and communication between, team members is easier. Establishing the overall audit strategy for the audit of a smaller entity need not be a complex or time consuming exercise; it varies according to the size and complexity of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period, based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph .07 of AU-C section 300.

Communications With Those Charged With Governance and Management

.44 AU-C section 260 explains that, among other matters, the auditor should communicate with those charged with governance (*a*) the auditor's responsibilities under GAAS and (*b*) an overview of the planned scope and timing of the audit.

The Audit Plan

.45 The auditor should develop an audit plan that includes a description of the following:

a. The nature and extent of planned risk assessment procedures, as determined under AU-C section 315

b. The nature, timing, and extent of planned further audit procedures at the relevant assertion level, as determined under AU-C section 330

c. Other planned audit procedures that are required to be carried out so that the engagement complies with GAAS

Direction, Supervision, and Review

.46 The nature, timing, and extent of the direction and supervision of engagement team members and review of their work vary, depending on many factors, including the following:

- The size and complexity of the entity
- The area of the audit
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members and a more detailed review of their work)
- The capabilities and competence of the individual team members performing the audit work

Accordingly, the auditor should plan the nature, timing, and extent of direction and supervision of engagement team members and the review of their work.

.47 AU-C section 220 establishes requirements and provides guidance on the direction, supervision, and review of audit work.

Changes to Planning Decisions During the Course of the Audit

.48 As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and, thereby, the resulting planned nature, timing, and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls. Accordingly, the auditor also should update and change the overall audit strategy and audit plan, as necessary, during the course of the audit.

Determining the Extent of Involvement of Professionals Possessing Specialized Skills

.49 The auditor should consider whether specialized skills are needed in performing the audit. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who either may be on the auditor's staff or an outside professional. In such circumstances, the auditor should have sufficient knowledge to communicate the objectives of the other professional's work; evaluate whether the specified audit procedures will meet the auditor's objectives; and evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures.

.50 An auditor may decide to seek the assistance of a professional with specialized skills necessary to complete various aspects of the engagement. These professionals may include valuation experts, appraisers, actuaries, tax specialists, and IT professionals. For example, the use of professionals possessing IT skills to determine the effect of IT on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive procedures is a significant aspect of many audit engagements. In determining whether such a professional is needed on the audit team, the auditor may consider such factors as the following:

- The complexity of the entity's systems and IT controls and the manner in which they are used in conducting the entity's business
- The significance of changes made to existing systems, or the implementation of new systems
- The extent to which data is shared among systems
- The extent of the entity's participation in electronic commerce
- The entity's use of emerging technologies
- The significance of audit evidence that is available only in electronic form

.51 Audit procedures that the auditor may assign to a professional possessing IT skills include inquiring of an entity's IT personnel how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed; inspecting systems documentation; observing the operation of IT controls; and planning and performing tests of IT controls.

Additional Considerations in Initial Audit Engagements

.52 The auditor should undertake the following activities prior to starting an initial audit:

a. Perform procedures required by AU-C section 220

b. Communicate with the predecessor auditor when there has been a change of auditors, in accordance with AU-C section 210

.53 The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not have the previous experience with the entity that is considered when planning recurring engagements. For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Arrangements to be made with the predecessor auditor (for example, to review the predecessor auditor's working papers [paragraphs .07 and .A2–.A11 of AU-C section 510])
- Any major issues (including the application of accounting principles or auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance, and how these matters affect the overall audit strategy and audit plan
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (paragraph .08 of AU-C section 510)
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance)

Investigatory Procedures for Individuals

.54 When credit information is requested about individuals who are new clients, the investigative procedures are subject to the Fair Credit Reporting Act.

.55 Under the Fair Credit Reporting Act, an individual is informed in writing that an investigative consumer report, including information about the individual's character, general reputation, personal characteristics, and mode of living is being made. The individual is also advised, within three days of the time the report is requested, that he or she may, within a reasonable time, by written request, be furnished disclosure of the nature and scope of the investigation.

Documentation

.56 The auditor should include in the audit documentation the following:

a. The overall audit strategy

b. The audit plan

c. Any significant changes made during the audit engagement to the overall audit strategy or the audit plan and the reasons for such changes

.57 The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and communicate significant issues to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing, and conduct of the audit.

.58 The documentation of the audit plan is a record of the planned nature, timing, and extent of risk assessment procedures and further audit procedures at the relevant assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

.59 A record of the significant changes to the overall audit strategy and the audit plan and resulting changes to the planned nature, timing, and extent of audit procedures explain why the significant changes were made and why the overall strategy and audit plan were finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Client Assistance Package

.60 When planning the audit engagement the auditor may consider preparing a client assistance package (CAP) or produced by client listing (PBC) and providing it to the client. The CAP or PBC is usually tailored to each specific engagement. The following is a list of analyses, schedules and other items that are often requested from the client prior to the start of an audit engagement:

Client Assistance Package (CAP)

Client: ______________________________
Audit Date: ______________________________

Request Reference	*Requested Support*	*Requested on*	*Requested to be received by*	*Received by auditor on*	*Status (Open, Partial, Closed)*	*Comments*
A.1	The general ledger as of the audit date.					
B.1	A reconciliation for each bank account.					
C.1	A trade accounts receivable aging as of the audit date.					
C.2	Accounts receivable confirmation letters, using template to be provided by the auditor.					
C.3	A schedule of accounts receivable from officers and employees.					
C.4	A schedule of bad debts written off during the year.					
D.1	A schedule of notes receivable as of the audit date. The notes should be available for inspection.					
E.1	An inventory listing as of the audit date.					
F.1	An analysis of transactions affecting marketable securities.					
G.1	An insurance schedule. The policies should be available for inspection.					
H.1	A rollforward schedule of property and equipment additions and retirements.					
H.2	A depreciation schedule.					
H.3	Copies of all leases, including equipment rental contracts, should be available for inspection.					

Client Assistance Package (CAP)						
Client: ______________ Audit Date: ______________						
Request Reference	*Requested Support*	*Requested on*	*Requested to be received by*	*Received by auditor on*	*Status (Open, Partial, Closed)*	*Comments*
H.4	A schedule of repairs and maintenance in excess of $____.					
I.1	A schedule of life insurance of officers.					
J.1	A schedule of accounts payable as of the audit date. The creditor's regular monthly statements for [date] should be retained and made available.					
K.1	A schedule of notes payable as of the audit date.					
L.1	A schedule of all transactions to partners' capital and drawing accounts.					
L.2	A copy of the partnership agreement or corporate charter should be available for inspection.					
M.1	A reconciliation of payroll accounts to the payroll system.					
M.2	Copies of employment contracts with salesmen or executives should be available for inspection.					
M.3	Copies of pension, profit sharing, deferred compensation, stock option agreements, and letters of acceptance from the Treasury Department, should be available for inspection.					
M.4	A schedule of each officer's salary and expense account payments.					
N.1	A schedule of contributions.					
O.1	A schedule of transactions with affiliated enterprises.					

(continued)

Client Assistance Package (CAP)						
Client: ________________						
Audit Date: ________________						
Request Reference	*Requested Support*	*Requested on*	*Requested to be received by*	*Received by auditor on*	*Status (Open, Partial, Closed)*	*Comments*
P.1	A schedule of tax expense.					
Q.1	A schedule of professional fees, including legal fees.					
R.1	The corporate stock book and minutes should be up to date and available for inspection.					

[*The next page is 3141.*]

AAM Section 3110

Assigning Personnel to the Engagement and Supervision

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
- AU-C section 230, *Audit Documentation*

QC Section:

- QC section 10, *A Firm's System of Quality Control*

General Comments

.01 Engagement planning includes procedures for assigning personnel to the engagement. Having procedures established provides the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. Generally, the more able and experienced the personnel assigned to a particular engagement, the less need for direct supervision.

.02 Some procedures regarding assignment of personnel to the engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all the procedures or be limited to those discussed. Overall firm guidance for assigning personnel to engagements is addressed in the Practice Aid *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (product nos. WQC-XX [online subscription] and APASQCS11E [eBook]), and in "A Firm's System of Quality Control" in section 10,200 of this manual. Sample quality control forms are available at section 10,300 of this manual, which are helpful in assigning personnel to engagements.

Engagement Planning Procedures

Audit Assignment Controls

.03 A time budget for the engagement is prepared to determine manpower requirements and to schedule field work. The engagement partner may approve the time budget prior to the beginning of field work. A time budget may have columns for budgeted time (in hours) for preliminary and final field work. Time budget forms differ depending upon firm preference and needs (see paragraphs .01–.02 of section 3160 of this manual for "Audit Time Budget—Sample A" and "Audit Time Budget—Sample B").

.04 Other alternatives include longer, more detailed sets of forms. These forms combine the features of a time budget, a source document for staff scheduling, and a job progress report that compares each assigned person's actual hours against the budget. Some firms use a shorter, less detailed form for jobs of less than a predetermined number of staff hours (for example, 100 hours) and a longer form for jobs requiring more time (see paragraph .04 of section 3160 of this manual for "Audit Status Analysis"). Some firms use a weekly (or daily) progress report (see paragraph .03 of section 3160 of this manual, for example). This report, submitted by the auditor in charge, shows the time actually spent in relation to the estimate, the estimated additional time required, and the estimated variance from the original estimate.

.05 Keeping the time budget and progress report current as the assignment progresses is vital for identifying and controlling timing because it is applied so that it can be compared to the budgeted time for that phase of the engagement. The time budget and progress report is carried in the working papers file and is filled in regularly by the auditor in charge for all persons applying time on the engagement.

Auditor Requirements

Assignment of Engagement Team

.06 The engagement partner should be satisfied that the engagement team and any auditor's external specialists, collectively, have the appropriate competence and capabilities to

a. perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements and

b. enable an auditor's report that is appropriate in the circumstances to be issued.

.07 A person with expertise in a specialized area of accounting or auditing is a member of the engagement team if that person performs audit procedures on the engagement. This applies whether that person is an employee of the firm or a nonemployee engaged by the firm. However, a person with such expertise is not a member of the engagement team if that person's involvement with the engagement is only consultation.

.08 When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's

- understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- understanding of professional standards and applicable legal and regulatory requirements.
- technical expertise, including expertise with relevant IT and specialized areas of accounting or auditing.
- knowledge of relevant industries in which the entity operates.
- ability to apply professional judgment.
- understanding of the firm's quality control policies and procedures.

Engagement Performance

Direction, Supervision, and Performance

.09 The engagement partner should take responsibility for the following:

a. The direction, supervision, and performance of the audit engagement in compliance with professional standards, applicable legal and regulatory requirements, and the firm's policies and procedures

b. The auditor's report being appropriate in the circumstances

.10 Direction of the engagement team involves informing the members of the engagement team of matters such as the following:

- Their responsibilities, including the need to comply with relevant ethical requirements and to plan and perform an audit with professional skepticism as required by AU-C section 200
- Responsibilities of respective partners when more than one partner is involved in the conduct of an audit engagement
- The objectives of the work to be performed

- The nature of the entity's business
- Risk-related issues
- Problems that may arise
- The detailed approach to the performance of the engagement

Discussion among members of the engagement team allows team members to raise questions so that appropriate communication can occur within the engagement team.

.11 Appropriate teamwork and training assist members of the engagement team to clearly understand the objectives of the assigned work.

.12 Supervision includes matters such as the following:

- Tracking the progress of the audit engagement
- Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, they understand their instructions, and the work is being carried out in accordance with the planned approach to the audit engagement
- Addressing significant findings or issues arising during the audit engagement, considering their significance, and modifying the planned approach appropriately
- Identifying matters for consultation or consideration by qualified engagement team members during the audit engagement

Considerations Relevant When a Member of the Engagement Team With Expertise in a Specialized Area of Accounting or Auditing Is Used

.13 When the engagement team includes a member with expertise in a specialized area of accounting or auditing, direction, supervision, and review of that engagement team member's work is the same as for any other engagement team member and may include matters such as the following:

- Agreeing with that member upon the nature, scope, and objectives of that member's work and the respective roles of, and the nature, timing, and extent of communication between, that member and other members of the engagement team
- Evaluating the adequacy of that member's work, including the relevance and reasonableness of that member's findings or conclusions and the consistency of those findings or conclusions with other audit evidence

Review

.14 The engagement partner should take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

.15 Under QC section 10 the firm's review responsibility policies and procedures are determined on the basis that suitably experienced team members review the work of other team members. The engagement partner may delegate part of the review responsibility to other members of the engagement team, in accordance with the firm's system of quality control.

.16 A review consists of consideration of whether, for example

- the work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- significant findings or issues have been raised for further consideration;

- appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- the nature, timing, and extent of the work performed is appropriate and without need for revision;
- the work performed supports the conclusions reached and is appropriately documented;
- the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

.17 On or before the date of the auditor's report, the engagement partner should, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

.18 Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant findings or issues to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement
- Significant risks
- Other areas that the engagement partner considers important

The engagement partner need not review all audit documentation but may do so. However, as required by AU-C section 230 the partner documents the extent and timing of the reviews.

Consultation

.19 The engagement partner should

a. take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;

b. be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

c. be satisfied that the nature and scope of such consultations are agreed with, and conclusions resulting from such consultations are understood by, the party consulted; and

d. determine that conclusions resulting from such consultations have been implemented.

.20 Members of the engagement team have a professional responsibility to bring to the attention of appropriate personnel matters that, in their professional judgment, are difficult or contentious and may require consultation.

.21 Effective consultation on significant technical, ethical, and other matters within the firm or, when applicable, outside the firm can be achieved when those consulted

- are given all the relevant facts that will enable them to provide informed advice and
- have appropriate knowledge, authority, and experience.

.22 The engagement team may consult outside the firm (for example, when the firm lacks appropriate internal resources). The engagement team may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services.

Engagement Quality Control Review

.23 For those audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner should

a. determine that an engagement quality control reviewer has been appointed;

b. discuss significant findings or issues arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and

c. not release the auditor's report until the completion of the engagement quality control review.

.24 The engagement quality control reviewer should perform an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the auditor's report. This evaluation should involve

a. discussion of significant findings or issues with the engagement partner;

b. reading the financial statements and the proposed auditor's report;

c. review of selected audit documentation relating to the significant judgments the engagement team made and the related conclusions it reached; and

d. evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.

Consideration Specific to Smaller, Less Complex Entities

.25 An engagement quality control review is required for audit engagements that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review.

Differences of Opinion

.26 If differences of opinion arise within the engagement team; with those consulted; or, when applicable, between the engagement partner and the engagement quality control reviewer, the engagement team should follow the firm's policies and procedures for resolving differences of opinion.

Documentation

.27 The auditor should include in the audit documentation the following:

- Issues identified with respect to compliance with relevant ethical requirements and how they were resolved
- Conclusions on compliance with independence requirements that apply to the audit engagement and any relevant discussions with the firm that support these conclusions
- Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements
- The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement

.28 The engagement quality control reviewer should document, for the audit engagement reviewed

a. that the procedures required by the firm's policies on engagement quality control review have been performed;

b. the date that the engagement quality control review was completed; and *c.* that the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments that the engagement team made and the conclusions it reached were not appropriate.

.29 Documentation of consultations with other professionals involving difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of

- the issue on which consultation was sought and
- the results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented.

.30 AU-C section 230 establishes requirements and provides guidance regarding the auditor's responsibility to prepare audit documentation for an audit of financial statements. Paragraph .A9 of AU-C section 230 states that it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit.

[*The next page is 3161.*]

AAM Section 3115

Independence

This section contains the following references from AICPA *Professional Standards*:

ET Sections:

- ET section 92, *Definitions*
- ET section 101, *Independence*

QC Section:

- QC section 10, *A Firm's System of Quality Control*

This section contains the following reference from other authoritative guidance:

- FASB *Accounting Standards Codification* (ASC) 810, *Consolidation*

General Comments

.01 In accordance with Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .01), of the AICPA Code of Professional Conduct, a member in public practice shall be independent in the performance of professional services, as required by standards promulgated by council. This includes, but is not limited to, attest engagements. Also note that additional requirements exist for public companies and companies subject to other governmental oversight. Attest engagements are those in which your firm attests—or affirms—that a client's financial or other information is reasonably stated. Examples of attest services are

- financial statement audits,
- financial statement reviews, and
- other attest services as defined in the Statements on Standards for Attestation Engagements.

.02 Third parties—investors, creditors, and others—rely on your firm's attestations about a client's financial information when making various business decisions. Therefore, attest services have value for third parties only if an *independent firm* renders the services. Accordingly, AICPA *Professional Standards* states that the auditor must maintain independence in mental attitude in all matters relating to the audit; therefore, your firm may perform attest services for a client *only* when it is independent of that client. Independence is not required to perform the following services, if these are the *only* services your firm provides to a client:

a. Tax preparation and advice

b. Consulting services (such as tax consulting or personal financial planning)

.03 Engagement planning includes procedures to provide the firm with reasonable assurance that all persons required to maintain independence, to the extent required by the AICPA Code of Professional Conduct and the regulations of other organizations, as applicable (for example, the SEC, and the Department of Labor), do so. The interpretations and rulings under Rule 101 of the AICPA Code of Professional Conduct contain examples of instances wherein a firm's independence will be considered to be impaired or not impaired.

.04 As stated in the following text, audit firms that perform audits of or perform other attest services for public companies or other SEC registrants should consult the independence rules of the SEC and the PCAOB.

.05 Other organizations that have established other independence requirements that a member should consult if applicable include the following:

- State boards of accountancy
- State CPA societies
- Federal and state agencies, such as the Governmental Accountability Office (GAO)

.06 Generally, the AICPA independence rules will apply to you in all situations involving an attest client. If an additional set of rules governing an engagement also applies, you should comply with the most restrictive rule or the most restrictive portions of each rule.

Maintaining Your Independence

.07 Maintaining your independence is your responsibility, not your firm's. As part of its quality control system, the firm is often required to address independence matters; however, ultimately it is up to you to follow firm policies and the independence rules. Many firms require you to certify your independence on a regular basis. The following are some suggestions that will help you to complete and sign that certification in good faith.

.08 *Gain an understanding of the independence rules and firm policies.* As a prerequisite to establishing and maintaining the independence, a good, working understanding of the basic independence rules is essential. Accordingly, in addition to this brief discussion about independence, CPAs should also consult and understand the AICPA Code of Professional Conduct. It is also important to be aware of the circumstances in which you and your immediate family meet the definition of a covered member (discussed in the following section in greater detail) and of the types of relationships you and your immediate family may have with the firm's clients that could impair independence. If you have any questions about independence matters, you may consult with someone in your firm who is knowledgeable about such matters, or you may seek the advice of the AICPA (ethics@aicpa.org). If your firm performs audits and other attest services for SEC registrants, you should also familiarize yourself with rules promulgated by the SEC and the PCAOB.

.09 The staff of the AICPA Professional Ethics Division prepared a plain-English digest of the AICPA independence rules to help you to understand independence requirements under the AICPA Code of Professional Conduct and, if applicable, other rule-making and standard-setting bodies. This digest of the AICPA independence rules is available on the AICPA Professional Ethics Division's website at www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf.

Covered Member

.10 Know when you meet the definition of a covered member. Whenever you are a *covered member* with respect to a particular attest client, you become subject to the highest possible level of independence restrictions (for example, restrictions on financial and business interests, and your family's employment). According to paragraph .07 of ET section 92, you are a *covered member* with respect to a client if you are

- an individual on the attest engagement team;
- an individual in a position to influence the attest engagement;
- a partner or manager who provides more than 10 hours of nonattest services to the attest client;
- a partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
- the firm, including the firm's employee benefit plans; or
- an entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles [GAAP] for consolidation purposes) by any of the individuals or entities described in the preceding items or by two or more such individuals or entities if they act together.

.11 However, due to their magnitude, two relationships with a client impair independence even when you are *not* a covered member. The following rules apply to partners and professional employees of a firm who are not covered members:

- No partner or professional employee may be simultaneously associated with an attest client during the period covered by the financial statements or during the period of the professional engagement as a
  - — director, officer, or employee (or in any capacity equivalent to a member of management),
  - — promoter, underwriter, or voting trustee, or
  - — trustee of any of the client's pension or profit-sharing trust.
- No partner or professional employee, his or her immediate family, or any group of such persons acting together may own more than 5 percent of an attest client's outstanding equity securities (or other ownership interests).

Networks and Network Firms

.12 According to Interpretation No. 101-17, "Networks and network firms," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .19), a network firm is required to be independent of financial statement audit and review clients of the other network firms if the use of the audit or review report by the client is not restricted, as defined by professional standards. For all other attest clients, consideration should be given to any threats the firm knows or has reason to believe may be created by network firm interests and relationships. If those threats are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level.

.13 To enhance capabilities to provide professional services, CPA firms may join larger groups, which typically are membership associations that are separate legal entities that are otherwise unrelated to their members. The associations facilitate their members' use of association services and resources; however, the associations themselves do not typically engage in the practice of public accounting or provide professional services to their members' clients or to other third parties. Firms and other entities in the association cooperate with the firms and other entities that are members of the association, thereby enhancing their capabilities to provide professional services. For example, a firm may become a member of an association in order to refer work to, or receive referrals from, other association members. According to Interpretation No. 101-17, that characteristic alone would not be sufficient for the association to constitute a network or for the firm to be considered a network firm.

.14 However, an association would be considered a network (and its members network firms) under Interpretation No. 101-17 if, in addition to cooperation among member firms for the purpose of enhancing their capabilities to provide professional services, one or more of the following additional characteristics of a network are present:

- The use of a common brand name (including common initials) as part of the firm name
- Common control (as defined by generally accepted accounting principles in the United States of America) among the firms through ownership, management, or other means
- Profits or costs, excluding costs of operating the association; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the firm
- Common business strategy that involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the association's strategy and are held accountable for performance pursuant to that strategy
- Significant part of professional resources
- Common quality control policies and procedures that firms are required to implement and that are monitored by the association

.15 When a firm participates in such an association and one or more of the preceding characteristics are present, the firm is considered a network firm. Any entity that the firm controls by itself or through one or more of its owners is also considered a network firm. In addition, any entity that can control the firm or that the firm is under common control with would also be considered a network firm.

.16 It is possible that not all firms in the association will meet one of the preceding characteristics. In such situations, only the subset of firms that meet one or more of the characteristics would be considered network firms.

.17 The independence requirements apply to any entity within the network that meets the definition of a network firm.

.18 In 2011, the staff of the AICPA Professional Ethics Division prepared nonauthoritative network firm implementation guidance and nonauthoritative frequently asked questions and case studies for network firms to assist practitioners to understand and implement Interpretation No. 101-17. This nonauthoritative guidance can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/Pages/default.aspx.

Family Members

.19 The investments and employment of certain family members may impair your independence. Know which of your family members meet the definition of *immediate family* and which ones meet the definition of *close relative* as defined in ET section 92.

.20 If you are a covered member with respect to a client, members of your immediate family (your spouse, spousal equivalent, or dependents [whether related or not]) should follow the same rules as you. So, for example, your spouse's investments should be investments that you could own under the rules. This would be the case even if your spouse keeps the investments in his or her own name or with a different broker.

.21 The following are exceptions to this general rule:

a. Your immediate family member's employment with a client would not impair your firm's independence provided he or she is not in a *key position*. A key position is one in which your immediate family member

   i. has primary responsibility for significant accounting functions that support material components of the financial statements;

   ii. has primary responsibility for preparing the financial statements; or

   iii. has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, CEO, president, CFO, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

b. Immediate family members in permitted employment positions may participate in certain employee benefit plans that are attest clients or are sponsored by an attest client, provided the plan is offered to all employees in comparable positions and the immediate family member does not serve in a position of governance for the plan or have the ability to supervise or participate in the plan's investment decisions or selection of investment options.

c. Immediate family members of *certain* covered members may have a financial interest in a client through an employee benefit plan (for example, retirement or savings account) provided the immediate family member has no other investment options available for selection, and when such option becomes available, the immediate family member selects the option and disposes of any direct or material indirect financial interest in the attest client.

d. Immediate family members in permitted employment positions of certain covered members may participate in share-based compensation arrangements and nonqualified deferred compensation plans provided certain safeguards are implemented.

e. The covered members whose families may invest or participate in the plans described in preceding items *c* and *d* are the following:

   i. Partners and managers who are covered members only because they provide nonattest services to the client.

   ii. Partners who are covered members only because they practice in the same office where the client's lead attest partner practices in connection with the engagement.

.22 Also note that at no time may any direct or material indirect financial interests in an attest client permitted by the preceding exceptions exceed 5 percent of the attest client's outstanding equity securities or other ownership interests.

.23 The close relatives of *most* covered members will be subject to some employment and financial restrictions. These covered members are

- persons on the attest engagement team,
- persons who can influence the attest engagement, and
- any partners in the office where the client's lead partner on the attest engagement practices.

.24 Close relatives are your

- nondependent children,
- siblings, or
- parents.

.25 Therefore, as a covered member, your close relative's employment by a client would impair independence if your relative held a key position with the client. However, if you are a covered member who provides only nonattest services to a client, then your close relative's employment by a client in a key position would not impair independence.

.26 Rules pertaining to your close relative's financial interests differ depending on why you are considered a covered member:

- If you are a covered member because you participate on the client's attest engagement team, your independence would be considered to be impaired if you are aware that your close relative has a financial interest in the client that either
  - — was material to your relative's net worth and of which you have knowledge or
  - — enables the relative to exercise significant influence over the client.
- If you are a covered member because you are able to influence the client's attest engagement or are a partner in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that
  - — is material to your relative's net worth and of which you or the partner have knowledge and
  - — enables your relative to exercise significant influence over the client.

Financial Relationships

.27 There are various types of financial interests and some of those interests affect independence. Although your firm and its employee benefit plans are also subject to the financial interest provisions of the independence rules (firms are included in the definition of *covered member*), here we focus on their application to individuals.

.28 As a covered member with respect to a particular client, you (and your spouse, or equivalent, and dependents) may not have a

- direct financial interest in that client, regardless of how immaterial it would be to your net worth.
- material indirect financial interest in that client.

> ***Note:*** The AICPA Code of Professional Conduct does not define or otherwise provide guidance on determining materiality. In determining materiality, you should apply professional judgment to all relevant facts and circumstances and refer to applicable guidance in the professional literature. Both qualitative and quantitative factors should be considered.

.29 In addition, if you commit to acquire a financial interest in a client with respect to which you are a covered member, your independence would be impaired. For example, if you sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

.30 According to Interpretation No. 101-15, "Financial relationships," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .17), a *financial interest* is an ownership interest in an equity or a debt security issued by an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.

.31 Examples of financial interests include shares of stock, mutual fund shares, debt security issued by an entity, partnership units, stock rights, options, or warrants to acquire an interest in a client; or rights of participation, such as puts, calls, or straddles.

.32 Direct financial interests are financial interests that are

- owned by you directly;
- under your control; or
- beneficially owned[1] by you through an investment vehicle, estate, trust, or other intermediary if you can either
  - — control the intermediary, or
  - — have the authority to supervise or participate in the intermediary's investment decisions.

For example, if you invest in a participant directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest in the investments held in your account.

.33 You also have a direct financial interest in a client when you have a financial interest in a client through one of the following:

- A partnership, if you are a general partner.

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[1] A financial interest is beneficially owned whether or not the individual or entity is the record owner of the interest but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or disposition of the interest or to receive the economic benefits of the ownership of the interest.

- A Section 529 savings plan, if you are the account owner.
- An estate, if you serve as an executor and meet certain other criteria.
- A trust, if you serve as the trustee and meet certain other criteria.

.34 Indirect financial interests arise if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary when you can neither control the intermediary nor have the authority to supervise or participate in the intermediary's investment decisions. For example, if you invest in a defined contribution plan that is not participant directed and you have no authority to supervise or participate in the plan's investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments, in addition to a direct financial interest in the plan.

.35 Extensive examples of various types of financial interests and whether they should be considered as direct or indirect financial interests, including investments in mutual funds, compensation, retirement and savings plans, Section 529 plans, trusts, partnerships, limited liability companies, and insurance products, can be found in Interpretation No. 101-15.

Employment or Association With Client

.36 As a partner or professional employee of your firm, independence would be considered to be impaired if you entered into certain business relationships with an attest client of the firm. Accordingly, you may not serve a client as any of the following:

- Director, officer, employee, or in any management capacity
- Promoter, underwriter, or voting trustee
- Stock transfer or escrow agent
- General counsel (or equivalent)
- Trustee for a client's pension or profit-sharing trust

.37 In essence, any time you are able to make management decisions on behalf of a client or exercise authority over a client's operations or business affairs, independence is considered impaired.

.38 Your independence is considered impaired even if you were a volunteer board member because you would be part of the client's governing body and therefore would be able to participate in the client's management decisions.

.39 If you are an honorary director or trustee for a client that is a not-for-profit charitable, civic, or religious organization, you will not be considered employed by or associated with the client. For this to occur,

a. your position is purely honorary.

b. you may not vote or participate in managing the organization.

c. your position is clearly identified as honorary in any internal or external correspondence.

.40 In addition, if you serve on a client's advisory board, you will not be considered employed by or associated with the client provided

- the advisory board's function is purely advisory.
- the advisory board does not appear to make decisions for the client.
- the advisory board and any decision making boards are separate and distinct bodies.
- common membership between the advisory board and any decision making groups is minimal.

Key Point

Before accepting an invitation to serve on a client's advisory board, a covered member may ask to review the advisory board's governing document to verify that the advisory board's function is indeed purely advisory and that the advisory board indeed does not make decisions for the client.

Serving as an Adjunct Faculty Member of an Educational Institution That Is Also an Attest Client

.41 A partner or professional employee of a CPA firm may serve as an adjunct faculty member of an educational institution (for example, college or university) that is also an attest client of the CPA firm, if all of the following criteria are met:

- The position is part-time and nontenured.
- The partner or professional employee does not assume any management responsibilities or set policies for the education institution.
- The partner or professional employee does not participate in any employee benefit plans offered by the educational institution, unless participation is required by the plan.
- The partner or professional employee is not in a *key position* (as defined in ET section 92) at the education institution.
- The partner or professional employee does not participate on the education institution's attest engagement team and cannot influence that attest engagement.

.42 When the relationship is terminated, in order for independence to be maintained, the member would need to comply with the requirements of the "Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client" section of Interpretation No. 101-1, "Interpretation of Rule 101," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .02).

Unpaid Fees

.43 If a client of the member's firm has not paid fees for previously rendered professional services, then independence is considered to be impaired if, when the report on the client's current year is issued, billed or unbilled fees, or a note receivable arising from such fees, remain unpaid for any professional services provided more than one year prior to the date of the report.

Affiliates

The following guidance (paragraphs .44–.47) is from Interpretation No. 101-18, "Application of the independence rules to affiliates," of Rule 101 (AICPA, *Professional Standards*, ET. sec. 101 par. .20) and was adopted by the Professional Ethics Executive Committee in August 2011. Interpretation No. 101-18 is effective for attest engagements performed on financial statements for periods beginning on or after January 14, 2014. Early implementation is permitted.

.44 Members are required to be independent of certain affiliates of a *financial statement attest client* (defined as audits and reviews of financial statements and compilations of financial statements when the member's compilation report does not disclose a lack of independence).

.45 The following entities should be considered affiliates of a financial statement attest client:

- An entity (for example, subsidiary, partnership, or limited liability company [LLC]) that a financial statement attest client can control.
- An entity in which a financial statement attest client, or an entity controlled by the financial statement attest client, has a direct financial interest that gives the financial statement attest client significant influence over such entity and that is material to the financial statement attest client.
- An entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity.
- An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.
- A sister entity of a financial statement attest client, if the financial statement attest client and sister entity are each material to the entity that controls both.
- A trustee that is deemed to control a trust financial statement attest client that is not an investment company.
- The sponsor of a single-employer employee benefit plan financial statement attest client.
- Any union or participating employer that has significant influence over a multiple or multiemployer employee benefit plan financial statement attest client.
- An employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client. A financial statement attest client that sponsors an employee benefit plan includes, but is not limited to, a union whose members participate in the plan and participating employers of a multiple or multiemployer plan.
- An investment adviser, general partner, or trustee of an investment company financial statement attest client (fund), if the fund is material to the investment adviser general partner or trustee, and they are deemed to have either control or significant influence over the fund. When considering materiality, members should consider investments in, and fees received from, the fund.

With respect to the preceding subparagraphs, the term *control(s)(led)* is as used in FASB ASC 810, for commercial entities and FASB ASC 958-805-20 for not-for-profit entities. The term *significant influence* is as used in FASB ASC 323-10-15.

.46 Members should apply the independence provisions of the AICPA Code of Professional Conduct to the affiliates of their financial statement attest clients, except in the following situations:

a. A covered member may have a loan to or from an individual who is an officer, a director, or a 10 percent or more owner of an affiliate of a financial statement attest client unless the covered member knows or has reason to believe that the individual is in such a position with such an affiliate. If the covered member knows or has reason to believe that the individual is an officer, a director, or a 10 percent or more owner of such an affiliate, the covered member should evaluate the effect that the relationship would have on the member's independence by applying the Conceptual Framework for AICPA Independence Standards.

b. A member or his or her firm may provide prohibited nonattest services to entities described under subparagraphs *c–j* of the definition of affiliate (defined in paragraph .58), provided that it is reasonable to conclude that the services do not create a self-review threat with respect to the financial statement attest client because the results of the nonattest services will not be subject to financial statement attest procedures. For any other threats that are created by the provision of the nonattest services that are not at an acceptable level (in particular, those relating to management participation), such threats should be eliminated or reduced to an acceptable level by the application of safeguards.

c. A firm will only have to apply conditions (1)–(6) of Interpretation No. 101-2, "employment or association with attest clients," of Rule 101 (AICPA, *Professional Standards*, ET. sec. 101 par. .04) if the former employee, by virtue of his or her employment at an entity described in the definition of affiliate (paragraph .45) would put the employee in a key position with respect to the financial statement attest client. Individuals in a position to influence the attest engagement and on the attest engagement team who are considering employment with an affiliate of a financial statement attest client will still need to report consideration of employment to an appropriate person in the firm and remove themselves from the financial statement attest engagement, even if the position with the affiliate is not a key position.

d. Immediate family members and close relatives of a covered member may be employed at an entity described in the definition of affiliate (defined in paragraph .45) in a key position, provided that the position does not put them in a key position with respect to the financial statement attest client.

.47 A member must expend best efforts to obtain the information necessary to identify a financial statement attest client's affiliates. If, after expending best efforts, a member is unable to obtain the information to determine which entities are affiliates of a financial statement attest client, the member is required to

a. discuss the matter, including the potential impact on independence, with those charged with governance;

b. document the results of that discussion and the efforts taken to obtain the information; and

c. obtain written assurance from the financial statement attest client that it is unable to provide the member with the information necessary to identify the client's affiliates.

.48 Entities that are deemed to be affiliates of financial statement attest clients are restricted entities. Paragraphs .49–.51 provide additional discussion on restricted entities.

Restricted Entities

.49 Be familiar with the firm's restricted entities. Restricted entities are those entities for whom the firm provides attest services and any affiliates (see paragraphs .44–.48). Many firms maintain a formal list or database of these entities. If yours is one of these firms, you should know how to access the list.

.50 Maintain the integrity of the restricted entity list. If you perform attest services, then you need to make sure that those clients, along with any affiliates, are identified as restricted entities of the firm.

.51 Consult the restricted entities list regularly. Get into the habit of referring to the firm's restricted entity list whenever you are considering changes in circumstances that could affect your independence. For example, you may consult the restricted entity list prior to

- making an investment or acquiring a financial interest in an entity.
- entering into a business relationship.
- obtaining a loan or refinancing an existing loan.
- having an immediate family member change employers or assume new responsibilities at an existing job.

Nonattest Services[2]

.52 Be aware of the rules relating to the performance of nonattest services. If you provide nonattest services to restricted entities, you should be familiar with Interpretation No. 101-3, "Nonattest Services," under Rule

[2] The staff of the AICPA Professional Ethics Division issued nonauthoritative guidance in the form of a frequently asked question (FAQ) regarding performance of nonattaest services. The FAQ document is available on the AICPA Professional Ethics Division's website at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.

101 (AICPA, *Professional Standards*, ET sec. 101 par. .05) that establishes standards and provides guidance regarding the performance of nonattest services. Interpretation No. 101-3 discusses the services that are permitted and prohibited under the ruling, as well as the member's responsibilities for establishing an understanding of the engagement with your client and documenting various aspects of the engagement. If your clients are SEC registrants, you should be aware of the more restrictive SEC rules in this area. Certain other regulators (for example, the GAO) may have more restrictive rules concerning nonattest services, which should be reviewed depending upon the circumstances of the engagement.

.53 The term *nonattest services* includes accounting and consulting services that are not part of an attest engagement; whereas the Code of Professional Conduct defines an *attest engagement* as one that requires independence under professional standards; for example, audits and reviews of financial statements or agreed upon procedures performed under the attestation standards. Nonattest services specifically addressed in the rules are as follows:

- Bookkeeping services
- Nontax disbursement services
- Internal audit assistance
- Benefit plan administration
- Investment advisory or management services
- Tax compliance services
- Corporate finance consulting or advisory
- Appraisal, valuation, or actuarial services
- Executive or employee search services
- Business risk consulting
- Information systems design, installation, or integration
- Forensic accounting services

.54 Interpretation No. 101-3 lists three general requirements in order to maintain independence when performing permitted nonattest services.

.55 The first of the three general requirements of Interpretation No. 101-3 states that a member should not assume management responsibilities for the attest client. (However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.)

.56 The second general requirement is that before performing nonattest services, the member should determine that the client has agreed to

- assume all management responsibilities.
- oversee the service, by designating an individual, preferably within senior management who possesses suitable skill, knowledge, and/or experience. The member should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or reperform the services.
- evaluate the adequacy and results of the services performed.
- accept responsibility for the results of the services.

To avoid assuming management responsibilities when providing nonattest services to the client, the member should be satisfied that management will be able to meet all these criteria, make an informed judgment on the results of the member's nonattest services, and be responsible for making the significant judgments and decisions that are the proper responsibility of management. In cases in which the client is unable or unwilling to assume these responsibilities (for example, the client cannot oversee the nonattest services provided or is unwilling to carry out such responsibilities due to lack of time or desire), the member's provision of these services would impair independence.

.57 The third general requirement is that before performing nonattest services, the member should establish and document in writing his or her understanding with the client (for example, the board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:

- Objectives of the engagement
- Services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

The understanding might be documented in a separate engagement letter, in the working papers, or in an internal memo, or it might be included in an engagement letter obtained in conjunction with an attest engagement.

.58 The second and third general requirements do not apply to certain routine activities performed by the member, such as, assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements that are part of the normal client-member relationship.

.59 In addition, the following are examples of the types of activities that impair independence:

- Setting policies or strategic direction for the client
- Directing or accepting responsibility for the actions of the client's employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards
- Authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Deciding which recommendations of the member or other third parties to implement or prioritize
- Reporting to those in charge of governance on behalf of management
- Accepting responsibility for the management of a client's project
- Accepting responsibility for the preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework
- Accepting responsibility for designing, implementing, or maintaining internal control
- Performing ongoing evaluations of the client's internal control as part of its monitoring activities

.60 Additionally, Interpretation No. 101-3 requires you comply with more restrictive independence provisions, if applicable, of certain regulators such as state boards of accountancy, the SEC, and the GAO.

.61 *Report any apparent violations*. If you become aware of any apparent violations of the independence rules, you should report these immediately to the person in your firm responsible for independence matters.

.62 The procedures employed at the engagement level should be designed to ascertain whether the firm and its partners and employees have complied with all applicable independence rules. Overall firm requirements for independence are addressed in QC section 10. Refer to section 10,000, "Quality Control," of this manual for additional discussion of QC section 10 and establishing and maintaining a firm's system of quality control.

Guidance Update

In January 2013, the AICPA Professional Ethics Division adopted revisions to Interpretation No. 101-3 that clarify that activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered nonattest services. In order to maintain independence when providing these nonattest services, the general requirements of this interpretation must be met as the services are not considered part of the attest engagement. The provision will be effective for engagements covering periods beginning on or after December 15, 2014. For example, the provision clarifies that a practitioner is allowed to prepare and maintain monthly account reconciliations for an attest client provided the client accepts responsibility for the services and the other general requirements of Interpretation No. 101-3 are met, such as ensuring that the client reviews and approves the account reconciliations and sufficiently understands the services performed to oversee them. This clarification was made because some have interpreted the current standard as prohibiting these activities and the change reinforces that they are permissible.

Effective August 31, 2012, revisions to this interpretation replaced the term *management functions* with *management responsibilities*, and added additional examples of activities that are considered to be the responsibilities of management and, therefore, impair independence. In August 2013, an additional revision to this interpretation was approved that is effective for engagements covering periods beginning on or after December 15, 2014. This revision requires members to consider whether the performance of multiple (otherwise permitted) nonattest services in the aggregate would create a significant threat to independence and, if so, to determine what, if any, safeguards could be applied to eliminate or reduce the threat to an acceptable level. When no safeguards are available to eliminate or reduce the threats to an acceptable level, independence would be considered impaired.

Independence Quality Controls

.63 Paragraph .22 of QC section 10, as further discussed in section 10,000 of this manual, states that the firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and, when applicable, others subject to independence requirements (including network firm personnel), maintain independence when required by relevant ethical requirements. Such policies and procedures should enable the firm to

- communicate its independence requirements to its personnel and, when applicable, others subject to them.
- identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safe guards, or, if considered appropriate (that is, effective safeguards cannot be applied), withdraw from the engagement when withdrawal is possible under applicable law or regulation.

.64 Such policies and procedures should require

- engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall effect, if any, on independence requirements.
- personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken.
- the accumulation and communication of relevant information to appropriate personnel so that
    - the firm and its personnel can readily determine whether they satisfy independence requirements;

— the firm can maintain and update information relating to independence; and

— the firm can take appropriate action regarding identified threats to independence that are not at an acceptable level.

.65 The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for

a. personnel to promptly notify the firm of independence breaches of which they become aware.

b. the firm to promptly communicate identified breaches of these policies and procedures to

i. the engagement partner who, with the firm, needs to address the breach; and

ii. other relevant personnel in the firm and, when appropriate, the network and those subject to the independence requirements who need to take appropriate action.

c. prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in item *b*(ii) of the actions taken to resolve the matter so that the firm can determine whether it should take further action.

.66 At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the requirements set forth in ET section 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies.

.67 The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

Additional Guidance

.68 It is recommended that the auditor document all procedures discussed in this section in his or her working papers.

.69 International independence standards are established by the International Federation of Accountants' (IFAC) International Ethics Standards Board for Accountants and can be found in section 290, *Independence—Audit and Review Engagements*, and section 291, *Independence—Other Assurance Engagements*, of the IFAC's Code of Professional Ethics for Professional Accountants. The IFAC's Code of Professional Ethics for Professional Accountants can be found at http://web.ifac.org/publications/international-ethics-standards-board-for-accountants/code-of-ethics.

.70 For additional guidance practitioners may refer to the AICPA Audit Risk Alert *Independence and Ethics Developments—2014/15* (product nos. ARAIET14P [print] and ARAIET14E [eBook] and reproduced in section 8240). This annual alert informs you of recent developments in the area of independence and ethics for members, including developments in international independence standards discussed previously in paragraph .69. Moreover, the alert helps you understand your independence requirements under the AICPA Code and, if applicable, certain other rule making and standard setting bodies. Also, the alert contains the AICPA Plain English Guide to Independence, which discusses the independence rules of the principal standard setting bodies in plain, straight forward English so you can understand and apply them with greater confidence and ease.

[*The next page is 3181.*]

AAM Section 3120

Obtaining an Understanding of the Entity and Its Environment

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 320, *Materiality in Planning and Performing and Audit*
- AU-C section 550, *Related Parties*

General

.01 AU-C section 315 establishes requirements and provides guidance regarding the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the entity's internal control.

.02 The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

.03 Audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*.

.04 Risk assessment procedures are designed to gather and evaluate information about the client and are not specifically designed as substantive procedures or as tests of controls. Nevertheless, in performing risk assessment procedures, the auditor may obtain evidence about relevant assertions or the effectiveness of controls.

Auditor Requirements

Risk Assessment Procedures and Related Activities

.05 The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

.06 Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an *understanding of the entity*), is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. The understanding of the entity establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit when, for example

- assessing risks of material misstatement of the financial statements;
- determining materiality in accordance with AU-C section 320;
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas for which special audit consideration may be necessary (for example, related party transactions, the appropriateness of management's use of the going concern assumption, considering the business purpose of transactions, or the existence of complex and unusual transactions);
- developing expectations for use when performing analytical procedures;
- responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and management's oral and written representations.

.07 Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and relevant assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

.08 The auditor is required to exercise professional judgment to determine the extent of the required understanding of the entity. The auditor's primary consideration is whether the understanding of the entity that has been obtained is sufficient to meet the objective stated in AU-C section 315. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

.09 The risks to be assessed include both those due to fraud and those due to error, and both are covered by AU-C section 315. However, the significance of fraud is such that further requirements and guidance are included in AU-C section 240 regarding risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud. See further discussion in section 3145, "Fraud."

.10 Although the auditor is required to perform all the risk assessment procedures described in paragraph .06 of AU-C section 315 in the course of obtaining the required understanding of the entity promulgated in paragraphs .12–.25 of AU-C section 315, the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed when the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include the following:

- Reviewing information obtained from external sources, such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications
- Making inquiries of the entity's external legal counsel or valuation specialists whom the entity has used

.11 The auditor should consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.

.12 If the engagement partner has performed other engagements for the entity, the engagement partner should consider whether information obtained is relevant to identifying risks of material misstatement.

.13 During planning, the auditor should consider the results of the assessment of the risk of material misstatement due to fraud along with other information gathered in the process of identifying the risks of material misstatements.

.14 The risk assessment procedures should include the following:

a. Inquiries of management and others within the entity who, in the auditor's professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error

b. Analytical procedures

c. Observation and inspection

.15 Paragraphs .A7–.A10 of AU-C section 315 (discussed in section 3155, "Analytical Procedures") provides guidance on analytical procedures performed as risk assessment procedures.

Inquiries of Management and Others Within the Entity

.16 Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor also may obtain information or a different perspective in identifying risks of material misstatement through inquiries of others within the entity and other employees with different levels of authority. For example

- inquiries directed toward those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- inquiries of employees involved in initiating, authorizing, processing, or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contract terms.
- inquiries directed toward marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

Examples of Inquires of Others Within the Entity

.17

Inquiries of these individuals (outside of management or the financial reporting process, or both)	*May help the auditor understand*
Those charged with governance	• the environment in which the financial statements are prepared. • whether they have knowledge of any fraud or suspected fraud. • how they exercise oversight of the entity's programs and controls that address fraud. • their views on where the company is most vulnerable to fraud. • how financial statements are used.
Internal audit personnel	• the design and operating effectiveness of internal control. • internal audit activities related to internal control over financial reporting. • whether management has responded satisfactorily to internal audit findings. • their views on where the company is most vulnerable to fraud.
Employees involved in the initiation, processing, or recording of complex or unusual transactions	• the controls over the selection and application of accounting policies related to those transactions. • the business rationale for those transactions.
IT systems users	• how IT users identify changes to IT systems and how frequently those changes occur. • how users "work around" IT systems for those circumstances where the IT system does not support them. • how logical access to data and applications is controlled. • how remote access to the system is controlled. • excessive system down time and other indicators that the system is not functioning properly.

Inquiries of these individuals (outside of management or the financial reporting process, or both)	*May help the auditor understand*
In-house legal counsel	• litigation. • compliance with laws and regulations. • fraud or suspected fraud. • warranties. • post-sales obligations. • arrangements such as joint ventures. • the meaning of certain contract terms.
Marketing, sales, or production personnel	• marketing strategies. • sales trends. • production strategies. • contractual arrangements with customers. • any pressures to meet budgets or change reported performance measures.

Analytical Procedures

.18 Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and nonfinancial information (for example, the relationship between sales and square footage of selling space or volume of goods sold).

.19 Analytical procedures may enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior audit and also may help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

.20 However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Considerations Specific to Smaller, Less Complex Entities

.21 Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

Observation and Inspection

.22 Observation and inspection may support inquiries of management and others and also may provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity's operations
- Documents (such as business plans and strategies), records, and internal control manuals
- Reports prepared by management (such as quarterly management reports and interim financial statements), those charged with governance (such as minutes of board of directors' meetings), and internal audit
- The entity's premises and plant facilities

Information Obtained in Prior Periods

.23 When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor should determine whether changes have occurred since the previous audit that may affect its relevance to the current audit.

.24 The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as

- past misstatements and whether they were corrected on a timely basis.
- the nature of the entity and its environment and the entity's internal control (including deficiencies in internal control).
- significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

.25 Paragraph .10 of AU-C section 315 requires the auditor to determine whether information obtained in prior periods remains relevant if the auditor intends to use that information for the purposes of the current audit. For example, changes in the control environment may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion Among the Engagement Team

.26 The engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner should determine which matters are to be communicated to engagement team members not involved in the discussion.

.27 The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement

- provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures.
- provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

This discussion may be held concurrently with the discussion among the engagement team that is required by paragraph .15 of AU-C section 240 to discuss the susceptibility of the entity's financial statements to fraud. AU- C section 240 further addresses the discussion among the engagement team about the risks of fraud.

.28 It is not always necessary or practical for the discussion to include all members in a single discussion (as in group audits), nor is it necessary for all the members of the engagement team to be informed of all the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team, including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

.29 Topics for audit team discussion may include the following:

- Areas of significant audit risk
- Unusual accounting procedures used by the client
- Important control systems
- Significant IT applications and how the client's use of IT may affect the audit
- Areas susceptible to management override of controls
- Materiality at the financial level and at the account level and tolerable misstatement
- How materiality will be used to determine the extent of testing
- The application of generally accepted accounting principles to the client's facts and circumstances and in light of the entity's accounting policies
- The need to
  — exercise professional skepticism throughout the engagement
  — remain alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred
  — follow up rigorously on any indications of a material misstatement

.30 *Considerations specific to smaller, less complex entities*. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

Understanding the Entity and Its Environment, Including the Entity's Internal Control

> ***Note:*** Appendix A, "Understanding the Entity and Its Environment," in AU-C section 315 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment.

The Entity and Its Environment

.31 The auditor should obtain an understanding of the following:

- Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework
- The nature of the entity, including

- — its operations;
- — its ownership and governance structures;
- — the types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives; and
- — the way that the entity is structured and how it is financed,

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

- The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- The entity's objectives and strategies and those related business risks that may result in risks of material misstatement.
- The measurement and review of the entity's financial performance.

Industry, Regulatory, and Other External Factors

.32 Relevant industry factors include industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the audit may consider include

- the market and competition, including demand, capacity, and price competition.
- cyclical or seasonal activity.
- product technology relating to the entity's products.
- energy supply and cost.

.33 The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business, the degree of regulation. For example, long term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team includes members with sufficient, relevant knowledge and experience, as required by AU-C section 220.

.34 Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include the following:

- Accounting principles and industry-specific practices
- Regulatory framework for a regulated industry
- Laws and regulations that significantly affect the entity's operations, including direct supervisory activities
- Taxation (corporate and other)
- Government policies currently affecting the conduct of the entity's business, such as monetary (including foreign exchange controls), fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies
- Environmental requirements affecting the industry and the entity's business

.35 AU-C section 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.

.36 Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

Nature of the Entity

.37 An understanding of the nature of an entity enables the auditor to understand such matters as

- whether the entity has a complex structure (for example, with subsidiaries or other components in multiple locations). Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or investments in entities formed to accomplish specific objectives are accounted for appropriately.
- the ownership and relations between owners and other people or entities. This understanding assists in determining whether related party transactions and balances have been identified and accounted for appropriately. AU-C section 550 addresses the auditor's considerations relevant to related parties.

.38 Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include

- business operations such as
  - the nature of revenue sources, products or services, and markets, including involvement in electronic commerce, such as Internet sales and marketing activities.
  - the conduct of operations (for example, stages and methods of production or activities exposed to environmental risks).
  - alliances, joint ventures, and outsourcing activities.
  - geographic dispersion and industry segmentation.
  - the location of production facilities, warehouses, and offices and the location and quantities of inventories.
  - key customers and important suppliers of goods and services.
  - employment arrangements (including the existence of union contracts, pension and other postemployment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
  - research and development activities and expenditures.
  - transactions with related parties.
- investments and investment activities such as
  - planned or recently executed acquisitions or divestitures.
  - investments and dispositions of securities and loans.
  - capital investment activities.
  - investments in nonconsolidated entities, including partnerships, joint ventures, and investments in entities formed to accomplish specific objectives.
- financing and financing activities such as
  - major subsidiaries and associated entities, including consolidated and nonconsolidated structures.
  - debt structure and related terms, including off balance sheet financing arrangements and leasing arrangements.
  - beneficial owners (local and foreign and their business reputation and experience) and related parties.
  - the use of derivative financial instruments.

- financial reporting such as
  - accounting principles and industry-specific practices, including industry-specific significant categories (for example, loans and investments for banks or research and development for pharmaceuticals).
  - revenue recognition practices.
  - accounting for fair values.
  - foreign currency assets, liabilities, and transactions.
  - accounting for unusual or complex transactions, including those in controversial or emerging areas (for example, accounting for stock-based compensation).

.39 Significant changes in the entity from prior periods may give rise to, or change risks of, material misstatement.

.40 An entity may form an entity that is intended to accomplish a narrow and well-defined purpose (for example, a variable interest entity), such as to effect a lease or a securitization of financial assets or to carry out research and development activities. It may take the form of a corporation, trust, partnership, or unincorporated entity. The entity on behalf of which an entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, and other parties may provide the funding to the latter.

.41 Financial reporting frameworks often specify detailed conditions that are deemed to amount to control or circumstances under which an entity should be considered for consolidation. The financial reporting frameworks also may specify different bases for recognition of income related to transactions with these entities. The interpretation of the requirements of such frameworks often involves a detailed knowledge of the relevant agreements involving an entity formed for a specific purpose.

The Entity's Selection and Application of Accounting Policies

.42 An understanding of the entity's selection and application of accounting policies may encompass such matters as

- the methods the entity uses to account for significant and unusual transactions.
- the effect of significant accounting policies in controversial or emerging areas for which a lack of authoritative guidance or consensus exists.
- significant changes in the entity's accounting policies and disclosures and the reasons for such changes.
- financial reporting standards, and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.
- the financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting standards.

.43 *Accounting processing*. In obtaining an understanding of how a client processes accounting information—from the initiation of the transaction to its inclusion in the financial statements—the auditor may focus on how the computer is used to process data and the ways in which transactions are valued, classified, and summarized in data files, journals, or ledgers. For some transactions, there may be several significant processing activities and accounting records, including the use of computer programs. Other transactions may involve only limited processing activities performed manually.

> ***Practical example:*** *At Jones Grocery, sales are initiated by customers and recorded in the cash register. At the end of the day the cash register totals are reconciled to the cash on hand, and a deposit is prepared for the day's receipts. On a weekly basis, the daily cash register tapes are batched for each store, forwarded to Mrs. Jones, and entered into the computer. The computer generates a sales register, a sales analysis report, and posts the sales totals to the general ledger. Also, the processing of inventory transactions (for example, receipt of goods, sales, and spoilage) involves several processing activities that are linked in the inventory module of the software package. On the other hand, recording depreciation expense is fairly simple. Fixed assets and the related depreciation are maintained on a computer spreadsheet, and each month, Mrs. Jones prepares a journal entry to record depreciation.*

.44 Understanding the accounting processing also involves understanding the information used for processing and when processing occurs. For example, when considering the completeness assertion, the auditor may obtain an understanding about whether transactions entered into the computer system are processed immediately or in batches and how frequently batches are processed.

.45 The processing of accounting information may involve *end user computing*. End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person.

> ***Practical example:*** *Mrs. Jones developed and maintains the fixed asset spreadsheet that serves as the source document for her monthly depreciation expense journal entry.*

.46 In general, the product of end user computing may be used to

- process significant accounting information outside of the off the shelf accounting software package (for example, the fixed-asset spreadsheet is separate from the Jones Grocery general ledger software package);
- make significant accounting decisions (for example, a spreadsheet application may be used to generate information used to write down inventory); and
- accumulate footnote information (for example, a spreadsheet may be used to calculate the five-year debt maturity disclosure).

.47 Generally, end users have no training in the formal computer application development process. Accordingly, applications developed by end users are often inadequately tested, and the development process is often not documented. This situation can cause significant difficulties for an organization if the end user computing application is critical to making business or financial decisions.

.48 The access to end user computing applications may also be an audit concern. Many computer applications used in end user computing come with on-line systems that are capable of restricting users to specific applications, specific departments, or even specific fields. Often, however, these access restrictions facilities are not implemented.

.49 To address these concerns and to ensure the end user applications process data completely and accurately, the auditor may look for control policies and procedures that

- require all significant end user applications to be adequately tested before use;
- prescribe documentation standards for significant end user applications;

- provide for adequate access controls to data;
- provide a mechanism to prevent or detect the use of incorrect versions of data files;
- provide for appropriate applications controls, for example, edit checks, range tests, or reasonableness checks; and
- support meaningful user reconciliations.

.50 *Accounting records, supporting information, and specific accounts*. In general, the auditor may identify the following for a client's significant accounts and transactions:

- Source documents
- Documents converted to computer media
- Computer files that are further processed in the flow of information to the general ledger and the financial statements
- Accounts (subsidiary or general ledger master files) affected by the transaction
- Relevant accounting reports, journals, and ledgers produced in the flow of information to the general ledger and the financial statements

.51 A client's accounting systems may create many documents, files, and reports that are useful for managing the organization; however, not all will be relevant to the financial statements.

> ***Practical example:*** *At Jones Grocery, the sales analysis report is used for management information and analysis. The documents and reports relevant to the financial statements are the daily cash register tapes and the computer generated sales register.*

.52 *Other significant events and conditions*. The entity's information system may capture other events and conditions that are significant to the financial statements. This might involve, for example, nonrecurring or unusual transactions or adjustments and nonrecurring estimates.

> ***Practical example:*** *A broken water line, which is an uninsured risk, spoiled a large amount of produce and dry goods in one of the Jones Grocery stores. Based on a list of the lost inventory provided by the store manager, Mrs. Jones recorded a large spoilage loss.*

.53 *Financial reporting process*. When gaining an understanding of the financial reporting process, the auditor may determine the extent of client procedures to prepare accounting estimates (when significant accounting estimates are called for) and information for significant disclosures. The auditor may also understand the way in which general ledger information is summarized to determine how the amounts and disclosures are reported in the financial statements.

Objectives, Strategies, and Related Business Risks

.54 The entity conducts its business in the context of industry, regulatory, and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's strategies and objectives may change over time.

.55 Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize the need for change also may give rise to business risk. Business risk may arise, for example, from

- the development of new products or services that may fail;
- a market that, even if successfully developed, is inadequate to support a product or service; or
- flaws in a product or service that may result in liabilities and reputational risk.

.56 An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement. This is because most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

.57 Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies, and related business risks that may result in a risk of material misstatement of the financial statements include

- industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- new products and services (a potential related business risk might be, for example, product liability is increased).
- expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation or a cost increase).
- regulatory requirements (a potential related business risk might be, for example, that legal exposure is increased).
- current and prospective financing requirements (a potential related business risk might be, for example, financing is lost due to the entity's inability to meet requirements).
- use of IT (a potential related business risk might be, for example, systems and processes are incompatible).
- the effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

.58 A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, also may have a longer term consequence, which may lead the auditor to consider whether those conditions, in the aggregate, indicate that substantial doubt could exist about the entity's ability to continue as a going concern. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are provided in appendix C, "Conditions and Events That May Indicate Risks of Material Misstatement," of AU-C section 315.

.59 Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraphs .16 and .A81–.A83 of AU-C section 315.

Measurement and Review of the Entity's Financial Performance

.60 Management and others will measure those things they regard as important. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud.

.61 The measurement and review of financial performance are not the same as the monitoring of controls (discussed as a component of internal control in paragraphs .23–.25 and .A102–.A107 of AU-C section 315), though their purposes may overlap as follows:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

.62 Examples of internally generated information used by management for measuring and reviewing financial performance may include

- key performance indicators (financial and nonfinancial) and key ratios, trends, and operating statistics.
- period-over-period financial analyses.
- budgets; forecasts; variance analysis; segment information; and divisional, departmental, or other level performance reports;
- employee performance measures and incentive compensation policies.
- comparisons of an entity's performance with that of competitors.

.63 External parties may also measure and review the entity's financial performance. For example, external information, such as analysts' reports and credit rating agency reports, may provide information useful to the auditor's understanding of the entity and its environment. Such reports may be obtained from the entity being audited or from websites.

.64 Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures also may indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared with that of other entities in the same industry. Such information, particularly if combined with other factors, such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

.65 *Considerations specific to smaller, less complex entities*. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that management relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, an increased risk of misstatements not being detected and corrected may exist.

Internal Control

.66 Refer to section 3125, "Obtaining an Understanding of Internal Control," of this manual for discussion regarding the auditor obtaining an understanding of internal control.

Documentation

.67 The auditor should include in the audit documentation the

- discussion among the engagement team required by paragraph .11 of AU-C section 315, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated;
- key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph .12 of AU-C section 315 and each of the internal control components specified in paragraphs .15–.25 of AU-C section 315 (discussed in section 3125 of this manual), the sources of information from which the understanding was obtained, and the risk assessment procedures performed. See section 6000, "Audit Documentation," of this manual for additional discussion on audit documentation.

[*The next page is 3201.*]

AAM Section 3125

Obtaining an Understanding of Internal Control

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 230, *Audit Documentation*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 610A, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

Introduction

.01 *Internal control* is broadly defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

.02 The previous definition reflects certain fundamental concepts that follow:

A process. Internal control is a process. It is not one event or circumstance but a series of ongoing tasks and activities.

People. Internal control is effected by people. It is not accomplished by policy manuals and forms but by the people of an organization and the actions that they take. People need to know their responsibilities and limits of authority.

Reasonable assurance. Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's objectives.

Achievement of objectives. Internal control is geared to the achievement of entity objectives. The definitions of these objectives provide auditors with a useful framework for understanding and analyzing internal control.

Adaptable to the entity structure. Internal control should be flexible in its application. This pertains to the how it's applied to the entity as a whole, or for a particular subsidiary, division, operating unit, or business process.

.03 Obtaining an understanding of and evaluating the design and implementation of controls is different from testing the operating effectiveness of controls. However, the same types of audit procedures are used. Accordingly, the auditor may decide it is efficient to test the operating effectiveness of controls at the same time the auditor is evaluating their design and determining that they have been implemented.

.04 Controls designed to prevent or detect misappropriations of assets may include controls relating to financial reporting and operations objectives. For example, use of a lockbox system for collecting cash or access controls, such as passwords that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. Depending on the auditor's professional judgment, his or her responsibility to understand internal control may be limited to those controls relevant to the reliability of financial reporting.

Auditor Requirements

The Entity's Internal Control

.05 The auditor should obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

.06 An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures.

.07 Section 4200, "Internal Control Framework," provides additional discussion on the general nature and characteristics of internal control and considerations when determining whether a control, individually or in combination with others, is relevant to the audit.

Nature and Extent of the Understanding of Relevant Controls

.08 When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting material misstatements. Implementation of a control means that the control exists and that the entity is using it. Assessing the implementation of a control that is not effectively designed is of little use, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency or material weakness in the entity's internal control.

> ***Practical example:*** *The Jones family owns and operates several neighborhood grocery stores in Anytown. On a monthly basis, the controller of Jones Grocery performs bank reconciliations for all the bank accounts. For planning purposes, the auditor of Jones Grocery should determine whether this control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements and determine whether the controller actually performs the reconciliations. Identifying and evaluating the design of controls are key parts of audit planning, while testing the implementation of those controls is not.*

.09 Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include

- inquiring of entity personnel.
- observing the application of specific controls.
- inspecting documents and reports.
- tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

.10 Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless some automation provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls, such as those over program changes. Tests of the operating effectiveness of controls are further described in AU-C section 330. Refer to section 5200, "Performing Tests of Controls," for additional discussion of AU-C section 330.

Components of Internal Control

Control Environment

.11 The auditor should obtain an understanding of the control environment. As part of obtaining this understanding, the auditor should evaluate whether

- management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and
- the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment.

.12 Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- *Communication and enforcement of integrity and ethical values*. Essential elements that influence the effectiveness of the design, administration, and monitoring of controls.
- *Commitment to competence*. Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- *Participation by those charged with governance*. Attributes of those charged with governance, such as
    - — their independence from management.
    - — their experience and stature.
    - — the extent of their involvement and the information they receive and the scrutiny of activities.
    - — the appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management.
    - — their interaction with internal and external auditors.
- *Management's philosophy and operating style*. Characteristics such as management's
    - — approach to taking and managing business risks.
    - — attitudes and actions toward financial reporting.
    - — attitudes toward information processing and accounting functions and personnel.
- *Organizational structure*. The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- *Assignment of authority and responsibility*. Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
- *Human resource policies and practices*. Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions.

.13 Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures, such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees management's views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

.14 Audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular when communication between management and other personnel may be informal, yet effective. For example, smaller entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Consequently, the attitudes, awareness, and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

.15 Section 3130, "Assessing the Risks of Material Misstatement," provides additional discussion on the effects of the control environment on the auditor's assessment of the risks of material misstatement.

The Entity's Risk Assessment Process

.16 The auditor should obtain an understanding of whether the entity has a process for

a. identifying business risks relevant to financial reporting objectives,

b. estimating the significance of the risks,

c. assessing the likelihood of their occurrence, and

d. deciding about actions to address those risks.

.17 If the entity has established a risk assessment process (referred to hereafter as the *entity's risk assessment process*), the auditor should obtain an understanding of it and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor should evaluate whether an underlying risk existed that the auditor expects would have been identified by the entity's risk assessment process. If such a risk exists, the auditor should obtain an understanding of why that process failed to identify it and evaluate whether the process is appropriate to its circumstances or determine if a significant deficiency or material weakness exists in internal control regarding the entity's risk assessment process.

.18 If the entity has not established such a process or has an ad hoc process, the auditor should discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor should evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances or determine whether it represents a significant deficiency or material weakness in the entity's internal control.

.19 *Considerations specific to smaller, less complex entities.* A smaller entity is unlikely to have an established risk assessment process in place. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

.20 Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. Risks can arise or change due to circumstances such as the following:

- Changes in operating environment
- New personnel
- New or revamped information systems

- Rapid growth
- New technology
- New business models, products, or activities
- Corporate restructurings
- Expanded foreign operations
- New accounting pronouncements
- Changes in economic conditions

The Information System, Including the Related Business Processes Relevant to Financial Reporting and Communication

.21 The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- The procedures within both IT and manual systems by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.
- The related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorize, record, process, and report transactions. This includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form.
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.

.22 The auditor should obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including

- communications between management and those charged with governance and
- external communications, such as those with regulatory authorities.

Control Activities Relevant to the Audit

.23 The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances.

.24 Control activities that are relevant to the audit are those that are

- required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs .30–.31 of AU-C section 315, or
- considered to be relevant in the professional judgment of the auditor.

.25 The auditor's professional judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

.26 The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas in which the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

.27 The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

.28 *Considerations specific to smaller, less complex entities*. The concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, smaller entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

.29 Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles, such as revenues, purchases, and employment expenses.

.30 In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT.

Monitoring of Controls

.31 The auditor should obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls.

.32 If the entity has an internal audit function, the auditor should obtain an understanding of the following in order to determine whether the internal audit function is likely to be relevant to the audit:

- The nature of the internal audit function's responsibilities and how the internal audit function fits in the entity's organizational structure
- The activities performed or to be performed by the internal audit function

.33 The entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing or reduce the extent of audit procedures to be performed. If the auditor determines that the internal audit function is likely to be relevant to the audit, AU-C section 610A applies.

Guidance Update

In February 2014, Statement on Standards (SAS) No. 128, *Using the Work of Internal Auditors* (AICPA, *Professional Standards*, AU-C sec. 610), was issued as part of the AICPA's Clarity Project to supersede SAS No. 65 (AU-C section 610A, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* [AICPA, *Professional Standards*]). SAS No. 128 addresses the external auditor's responsibilities if using the work of internal auditors. Using the work of internal auditors includes (*a*) using the work of the internal audit function in obtaining audit evidence and (*b*) using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor. SAS No. 128 requires, among other things, that as a pre-requisite to being able to use the work of the internal audit function, the external auditor evaluate the application by the internal audit function of a *systematic and disciplined approach*, including quality control. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the existence, adequacy, and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation, and reporting, the nature and extent of which is commensurate with the nature and size of the internal audit function relative to the complexity of the entity. Another factor that may be considered is whether the internal audit function has appropriate quality control policies and procedures or quality control requirements in standards set by relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements, such as conducting periodic external quality assessments. The ASB believes that relative to SAS No. 65, this requirement represents an additional and explicit evaluation that the external auditor is required to perform to conclude on the appropriateness of using the work of internal auditors in obtaining audit evidence. SAS No. 128 is effective for audits of financial statements for periods ending on or after December 15, 2014.

.34 The objectives of an internal audit function and, therefore, the nature of its responsibilities and its status within the organization, vary widely and depend on the size and structure of the entity and the requirements of management and, when applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency, and effectiveness of operations, for example, and, accordingly, may not relate to the entity's financial reporting.

.35 If the nature of the internal audit function's responsibilities is related to the entity's financial reporting, the external auditor's consideration of the activities performed or to be performed by the internal audit function may include review of the internal audit function's audit plan for the period, if any, and discussion of that plan with the internal auditors.

.36 The auditor should obtain an understanding of the sources of the information used in the entity's monitoring activities and the basis upon which management considers the information to be sufficiently reliable for the purpose.

.37 Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of the following is required as part of the auditor's understanding of the entity's monitoring activities component of internal control:

- The sources of the information related to the entity's monitoring activities
- The basis upon which management considers the information to be sufficiently reliable for the purpose

Other Considerations Regarding Components of Internal Control

.38 Some control components, for example the control environment, will have a pervasive effect on the entity's activities. Other components, for example control activities, will be directed primarily toward the achievement of one or more of the three objectives described in paragraph .01 in this section. Auditors are generally interested only in those components of internal control that have a pervasive effect on the entity and those that are directly related to the reliability of financial reporting.

.39 The aforementioned internal control framework, the relationship between an entity's objectives and internal control components, is discussed in more detail in section 4200 of this manual.

.40 The internal control framework described here and in section 4200 of this manual is only a means to help auditors consider the effect of an entity's internal control in an audit. An auditor's primary concern is *not* the classification of a specific control into any particular component and related objective. Rather, an auditor's primary concern is whether, and how, a specific control prevents or detects and corrects material misstatements in relevant assertions related to classes of transactions, account balances, or disclosures, rather than its classification into any particular component. Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect and correct material misstatements in financial statement assertions. Such controls may exist in any of the five components.

> ***Practical example:*** *Andrea Auditor audits Jones Grocery. As on all audits, she should obtain an understanding of internal control sufficient to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures. To achieve this, she organizes her inquiries and other procedures to understand each of the five components of internal control that relate to the financial reporting objective. As a result of performing her procedures, she discovers the client's bank reconciliation procedures. Should a bank reconciliation be considered a* control activity*? What about the fact that someone follows up and investigates old or unusual reconciling items. Is that considered a* monitoring activity*?*
>
> *The issue of how to classify a particular control is irrelevant for Andrea's purposes. As an auditor, her primary consideration is to understand how the bank reconciliations, whether individually or in combination with other controls, affect financial statement assertions relating to cash.*

Other Considerations When the Auditor Obtains an Understanding of Internal Control

.41 Auditors might consider the types of misstatements that occurred in prior audits (for example, whether they were associated with accounting estimates, whether they were routine errors that resulted from a lack of control consciousness, or whether they resulted from lack of sufficient personnel). This knowledge of prior misstatements can help an auditor focus his or her inquiries on those areas and whether changes have been made to internal control to prevent those misstatements in the future.

.42 In a continuing audit, the auditor may already have significant experience with and documentation of internal control. In these situations, this knowledge from previous audits may allow the auditor to focus on system changes.

> ***Practical example:*** *Jones Grocery purchased a commercially available software package for independent grocers. During 20X1, Jones installed the general ledger system and the cash receipts/disbursements and accounts payable modules. As part of performing her 20X1 audit, Andrea Auditor obtained an understanding of the software package and the modules that were installed. For her 20X2 audit, Andrea should focus on changes made to the system since 20X1. For example, she might inquire about the installation of other modules (such as inventory) or updated versions of the software package.*

.43 Some controls are documented in policy and procedure manuals, flowcharts, source documents, journals, and ledgers. In these cases, inspection of the documentation and inquiries of entity personnel may provide a sufficient understanding to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures.

> ***Practical example:*** *When Jones Grocery receives a bill, it is input directly into the accounts payable module of their software package. The computer generates an accounts payable aging and a cash requirements report that indicates when each bill should be paid. The accounts payable module interfaces with the general ledger system to automatically post and update the appropriate general ledger account whenever bills are received or paid. To obtain her understanding of the accounts payable system, Andrea performed a "walk-through." She made inquiries of Jones personnel and obtained copies of bills and the reports generated by the computer. She "walked through" the example bills to see how they were included in the computer reports and how totals from those reports were posted to the general ledger. She also made inquiries related to the completeness assertion, that is, how does Jones ensure that* all *bills are entered into the system? Andrea observed the Jones employee performing those control procedures*.

.44 Documentation may not be available for some controls. For example, the understanding of certain aspects of the control environment, such as management integrity, may be obtained through previous experience updated by inquiries of management and observation of their actions. Although documentation may not be available, this does not alter the requirement that the auditor document his or her understanding of the components of internal control.

Assessing Internal Control Strengths and Weaknesses

.45 When obtaining an understanding of internal control, the auditor may consider the *collective* effect of strengths and weaknesses in various control environment factors. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by top management to overstate earnings.

.46 Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms (for example, high, medium, or low).

.47 Internal control strengths may indicate account balances, transaction classes, or assertions where you can assess control risk at low or moderate level. Internal control weaknesses usually indicate areas where substantive procedures may be required. However, in situations where electronic evidence (information transmitted, processed, maintained, or accessed by electronic means) is significant, testing of the related internal control generally is necessary to obtain sufficient competent audit evidence.

.48 In rare circumstances, the auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious that the auditor may conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records also may be so serious that the auditor may conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an opinion on the financial statements.

.49 In situations in which the auditor concludes that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements, AU-C section 705 establishes requirements and provides guidance regarding the auditor's determination of whether to express a qualified or adverse opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement when withdrawal is possible under applicable law or regulation.

Additional Resources for Practical Guidance

Readers may refer to appendix M, "Illustrative Audit Documentation Case Study: Young Fashions, Inc.," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* for examples of how to document your understanding of internal control. Appendix M contains several subappendixes (appendixes M-1–M-6). Those that are particularly relevant to internal control include the following:

- Appendix M-2, "Young Fashions: Evaluation of Entity-Level Controls," provides example documentation of the auditors evaluation of entity-level controls, except for IT general controls. Appendix M-2 illustrates how to document your understanding of the controls relevant to the audit, including (*a*) an evaluation of whether the design of the control, individually or in combination, is capable of effectively preventing or detecting and correcting material misstatements and (*b*) a determination of whether the control exists and the entity is using it.
- Appendix M-2-1, "Young Fashions: Procedures Performed to Evaluate Entity-Level Controls," provides illustrative documentation for the risk assessment and other procedures an auditor performs to obtain the required understanding about internal control and the source of that understanding.
- Appendix M-3, "Young Fashions: Understanding of Internal Control—IT General Controls," provides example documentation of the auditors evaluation of IT general controls.
- Appendix M-4, "Young Fashions: Evaluation of Activity-Level Controls—Wholesale Sales," provides example documentation of an evaluation of activity-level controls. This case study presents only one class of transactions, sales. In practice, the auditor would evaluate activity-level controls for each significant class of transactions.

Documenting the Understanding

.50 The auditor should include in the audit documentation the

- discussion among the engagement team required by paragraph .11 of AU-C section 315, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated, and
- key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph .12 of AU-C section 315 and each of the components of internal control specified in paragraphs .15–.25 of AU-C section 315, the sources of information from which the understanding was obtained, and the risk assessment procedures performed.

.51 The manner in which the requirements of paragraph .33 of AU-C section 315 are documented is for the auditor to determine exercising professional judgment. For example, in audits of smaller entities, the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan. Similarly, the results of the risk assessment may be documented separately, or they may be documented as part of the auditor's documentation of further audit procedures. The form and extent of the documentation is influenced by the nature, size, and complexity of the entity and its internal control; availability of information from the entity; and the audit methodology and technology used in the course of the audit.

.52 For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of the understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

.53 The extent of documentation also may reflect the experience and capabilities of the members of the audit engagement team. Provided that the requirements of AU-C section 230 are met, an audit undertaken by an engagement team comprising less experienced individuals may contain more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

.54 For recurring audits, certain documentation may be carried forward and updated as necessary to reflect changes in the entity's business or processes.

[*The next page is 3221.*]

AAM Section 3130

Assessing the Risks of Material Misstatement

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 230, *Audit Documentation*
- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

General

.01 Knowledge an auditor acquires about a client encompasses a broad range of information, including the following:

- Industry, regulatory, and other external factors affecting the client
- The nature of the client, including its operations and organizational structure
- The client's objectives, strategies, and related business risks, some of which will give rise to risks affecting the financial statements
- The client's selection and application of accounting policies
- How management measures and reviews the company's financial performance
- An understanding of the internal controls that are in use at the entity, including an understanding of the use of IT and the controls designed and used within the IT system

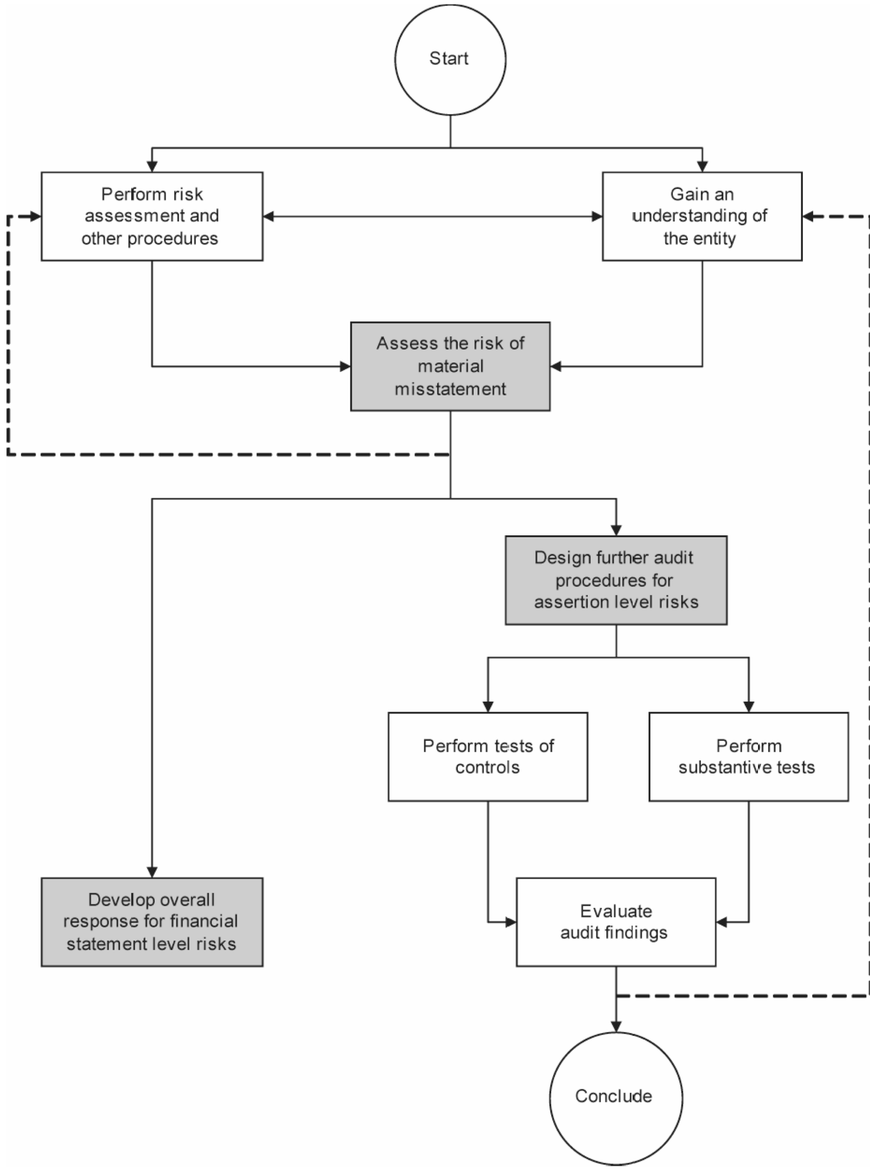
This knowledge of a client forms the basis for identifying and assessing risks of material misstatement at the financial statement and relevant assertion levels.

Auditor Requirements

Identifying and Assessing the Risks of Material Misstatement

.02 To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at

- the financial statement level and
- the relevant assertion level for classes of transactions, account balances, and disclosures.



.03 For this purpose, the auditor should

- identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements;
- assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test; and
- consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Effect of the Control Environment on the Assessment of the Risks of Material Misstatement

.04 Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance because one of their roles is to counterbalance pressures on management regarding financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment with regard to participation by those charged with governance is therefore influenced by such matters as

- their independence from management and their ability to evaluate the actions of management.
- whether they understand the entity's business transactions.
- the extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework.

.05 An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.

.06 The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, particularly with regard to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or data or unauthorized transactions to be processed. As explained in AU-C section 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

.07 The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and, thereby, the auditor's assessment of the risks of material misstatement.

Observations and Suggestions

The mere documentation of information that you gather about the client and its environment is not sufficient to support an assessment of the risks of material misstatement. You are required to then evaluate that information and use it to form an understanding of your client that will allow you to assess risk and design appropriate other audit procedures.

Assessing Risks of Material Misstatement at the Financial Statement Level

.08 Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level (for example, through management override of internal control). Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

.09 Risks at the financial statement level may derive, in particular, from a deficient control environment (although these risks also may relate to factors such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

.10 The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example

- concerns about the integrity of the entity's management may be serious enough to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.

- concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

.11 AU-C section 705 addresses the determination of whether a need exists for the auditor to express a qualified or adverse opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement when withdrawal is possible under applicable law or regulation.

.12 Characteristics of financial statement level risks that are relevant for audit purposes include the following:

Financial statement level risks can affect many assertions. For example, a lack of control over journal entries increases the risk that an inappropriate journal entry could be posted to the general ledger as part of the period-end financial reporting process. The posting of an inappropriate journal entry may not be isolated to one general ledger account but potentially could affect any account. In general, overall audit risk increases when the magnitude or scope of identified risks of material misstatement are not known.

Assessing financial statement level risks requires significant judgment. For example, suppose that while performing risk assessment procedures to gather information about the control environment, the auditor discovered weaknesses relating to the hiring, training, and supervision of entity personnel. These weaknesses result in increased risks of a misstatement of the financial statements, but it will be a matter of the auditor's professional judgment to determine the following:

- The accounts and relevant assertions that could be affected
- The likelihood that a financial statement misstatement will result from the increased risks
- The significance of any misstatement

Risks at the financial statement level may not be identifiable with specific assertions. Control weaknesses at the financial statement level can render well designed activity level controls ineffective. For example, a significant risk of management override can potentially negate existing controls and procedures at the activity level in many accounts and for many assertions. Linking such a risk to specific accounts and assertions may be very difficult or may not even be possible. As another example, a client may have excellent data input controls at the application level. But if poorly designed, IT general controls may allow many unauthorized personnel the opportunity to access and inappropriately change the data, rendering the well-designed input controls ineffective. Also, strengths in financial statement level controls such as an overall culture of ethical behavior may increase the reliability of controls that operate at the activity level. Determining the extent to which financial statement level controls affect the reliability of specific activity level controls (and therefore the assessment of the risks of material misstatement) is subjective and may vary from client to client.

Assessing Risks of Material Misstatement at the Relevant Assertion Level

.13 Risks of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the relevant assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many relevant assertions.

The Use of Assertions

.14 In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

Categories of Assertions

	Description of Assertions		
	Classes of transactions and events for the period under audit	*Account balances at the end of the period*	*Presentation and disclosure*
Occurrence/Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred and pertain to the entity.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/valuation and allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

.15 The auditor may use the assertions as described previously or may express them differently, provided that all aspects described previously have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances. As another example, there may not be a separate assertion related to cutoff of transactions and events when the occurrence and completeness assertions include appropriate consideration of recording transactions in the correct accounting period.

Relevant Assertions

.16 *Relevant assertions* are assertions that have a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated and, as such, are assertions that have a meaningful bearing on whether the account is fairly stated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of internal controls. Not all assertions pertaining to a particular account balance will always be relevant. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance but is relevant to the related allowance accounts. Additionally, the auditor might, in some circumstances, focus on the presentation and disclosure assertions separately in connection with the period-end financial reporting process.

.17 Paragraph .26*b* of AU-C section 315 requires the auditor to use relevant assertions for classes of transactions, account balances, and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor also is required to use relevant assertions in assessing risks by relating the identified risks to what can go wrong at the relevant assertion, taking into account the relevant controls that the auditor intends to test, and designing further audit procedures that are responsive to the assessed risks.

.18 For each significant class of transactions, account balance, and disclosure, the auditor is required to determine the relevance of each of the financial statement assertions. Identifying relevant assertions includes determining the source of likely potential misstatements in each significant class of transactions, account balance, and disclosure. Attributes indicating the potential relevance of an assertion include the

a. nature of the assertion;

b. volume of transactions or data related to the assertion; and

c. nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion.

Process of Identifying Risks of Material Misstatement

.19 Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

.20 The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement, and the list of examples is not necessarily complete:

- Operations in regions that are economically unstable (for example, countries with significant currency devaluation or highly inflationary economies)
- Operations exposed to volatile markets (for example, futures trading)
- Operations that are subject to a high degree of complex regulation
- Going concern and liquidity issues, including loss of significant customers
- Constraints on the availability of capital and credit
- Changes in the industry in which the entity operates
- Changes in the supply chain
- Developing or offering new products or services or moving into new lines of business
- Expanding into new locations
- Changes in the entity, such as large acquisitions or reorganizations or other unusual events
- Entities or business segments likely to be sold
- The existence of complex alliances and joint ventures

- Use of off-balance-sheet finance, investments in entities formed to accomplish specific objectives, and other complex financing arrangements
- Significant transactions with related parties
- Lack of personnel with appropriate accounting and financial reporting skills
- Changes in key personnel, including departure of key executives
- Deficiencies in internal control, especially those not addressed by management
- Inconsistencies between the entity's IT strategy and its business strategies
- Changes in the IT environment
- Installation of significant new IT systems related to financial reporting
- Inquiries into the entity's operations or financial results by regulatory or government bodies
- Past misstatements, history of errors, or a significant amount of adjustments at period-end
- Significant amount of nonroutine or nonsystematic transactions, including intercompany transactions and large revenue transactions at period-end
- Transactions that are recorded based on management's intent (for example, debt refinancing, assets to be sold, and classification of marketable securities)
- Application of new accounting pronouncements
- Accounting measurements that involve complex processes
- Events or transactions that involve significant measurement uncertainty, including accounting estimates
- Pending litigation and contingent liabilities (for example, sales warranties, financial guarantees, and environmental remediation)

.21 Information from sources external to the client may be helpful in understanding the client and identifying risks of material misstatement. Examples of information sources external to the client that may be helpful include

- external legal counsel.
- experts that the company has used who may be relevant for financial reporting purposes, for example a valuation expert.
- trade and economic journals.
- regulatory or financial publications.

Relating Controls to Assertions

.22 In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

.23 Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness of assertions for the inventory account balance.

.24 Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks That Require Special Audit Consideration

.25 As part of the assessment of the risks of material misstatement described in paragraph .26 of AU-C section 315, the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, significant risks. Significant risks are those that require special audit consideration. This special consideration means that the auditor should

- obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks.
- perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.
- if relying on the operating effectiveness of controls over a risk the auditor has determined to be a significant risk, the auditor should test the operating effectiveness of those controls in the current period.
- document those risks you have identified as significant and a linkage to the related audit procedures performed.

In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk.

.26 In exercising professional judgment about which risks are significant risks, the auditor should consider at least

- whether the risk is a risk of fraud;
- whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention;
- the complexity of transactions;
- whether the risk involves significant transactions with related parties;
- the degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

.27 If the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks.

Identifying Significant Risks

.28 Paragraphs .15 and .22 of AU-C section 330 describe the consequences for further audit procedures of identifying risks as significant.

.29 Significant risks often relate to significant *nonroutine transactions* and matters that require significant judgment. Matters that require significant judgment may include the development of accounting estimates for which a significant measurement uncertainty exists. Routine, noncomplex transactions that are subject to systematic processing are less likely to give rise to significant risks. *Nonroutine transactions* are transactions that are unusual, either due to size or nature, and that therefore occur infrequently.

.30 Risks of material misstatement may be greater for significant nonroutine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment
- Greater manual intervention for data collection and processing
- Complex calculations or accounting principles
- The nature of nonroutine transactions, which may make it difficult for the entity to implement effective controls over the risks
- Significant related party transactions

.31 Risks of material misstatement may be greater for matters that require significant judgment, such as the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or it may require assumptions about the effects of future events (for example, judgment about fair value).

.32 AU-C section 240 addresses the auditor's responsibilities regarding the identification and assessment of the risks of material misstatement due to fraud.

Understanding Controls Related to Significant Risks

.33 Although risks relating to significant nonroutine transactions or matters that require significant judgment are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from nonroutine transactions or matters that require significant judgment includes whether and how management responds to the risks. Such responses might include

- control activities, such as a review of assumptions by senior management or specialists.
- documented processes for estimations.
- approval by those charged with governance.

.34 For example, when nonrecurring events occur, such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate specialists (for example, internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

.35 In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls may be a significant deficiency or a material weakness. In these circumstances, the auditor also may consider the implications for the auditor's risk assessment.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

.36 With respect to some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit, and the auditor should obtain an understanding of them.

.37 Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions, such as an entity's revenue, purchases, and cash receipts or cash payments.

.38 When such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures regarding the risk. For example, the auditor may consider this to be the case when a significant amount of an entity's information is initiated, authorized, recorded, processed, or reported only in electronic form, such as in an integrated system. In such cases

- audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- the potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

.39 Examples of situations in which the auditor may find it impossible to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence that certain relevant assertions are not materially misstated include the following:

- An entity that conducts its business using IT to initiate orders for the purchase and delivery of goods based on predetermined rules of what to order and in what quantities and to pay the related accounts payable based on system-generated decisions initiated upon the confirmed receipt of goods and terms of payment. No other documentation of orders placed or goods received is produced or maintained, other than through the IT system.
- An entity that provides services to customers via electronic media (for example, an Internet service provider or a telecommunications company) and uses IT to create a log of the services provided to its customers, initiate and process its billings for the services, and automatically record such amounts in electronic accounting records that are part of the system used to produce the entity's financial statements.

.40 Paragraph .08 of AU-C section 330 describes the consequences for further audit procedures of identifying risks as significant and for which substantive procedures alone do not provide sufficient appropriate audit evidence.

Revision of Risk Assessment

.41 The auditor's assessment of the risks of material misstatement may change during the course of the audit as additional audit evidence is obtained. In circumstances in which the auditor obtains audit evidence from performing further audit procedures or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and modify the further planned audit procedures accordingly.

.42 During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that controls are operating effectively. In performing tests of controls, the auditor may obtain audit evidence that controls were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures, the auditor may detect misstatements in amounts or frequency that is greater than is consistent with the auditor's risk assessment. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity, and the further planned audit procedures may not be effective in detecting material misstatements.

.43 Paragraphs .27–.28 of AU-C section 330 establish additional requirements with respect to the auditor's evaluation of the sufficiency and appropriateness of audit evidence.

Documentation

.44 In accordance with paragraph .33 of AU-C section 315, the auditor should include the following in the audit documentation:

- a discussion among the engagement team, the significant decisions reached, how and when the discussion occurred, and the audit team members who participated;
- the key elements of the understanding obtained regarding each of the aspects of the entity and its environment and each of the internal control components, the sources of information from which the understanding was obtained, and the risk assessment procedures performed;
- the identified and assessed risks of material misstatement at the financial statement level and at the relevant assertion level; and
- risks identified and related controls about which the auditor has obtained an understanding, and a link to the auditor procedures performed in relation to these risks.

.45 The manner in which the requirements of paragraph .33 of AU-C section 315 are documented is for the auditor to determine exercising professional judgment. For example, in audits of smaller entities, the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan. Similarly, the results of the risk assessment may be documented separately, or they may be documented as part of the auditor's documentation of further audit procedures. The form and extent of the documentation is influenced by the nature, size, and complexity of the entity and its internal control; availability of information from the entity; and the audit methodology and technology used in the course of the audit.

.46 For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of the understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

.47 The extent of documentation also may reflect the experience and capabilities of the members of the audit engagement team. Provided that the requirements of AU-C section 230 are met, an audit undertaken by an engagement team comprising less experienced individuals may contain more detailed documentation than one that includes experienced individuals in order to help them to obtain an appropriate understanding of the entity.

.48 For recurring audits, certain documentation may be carried forward and updated as necessary to reflect changes in the entity's business or processes.

[*The next page is 3271.*]

AAM Section 3140

Materiality and Misstatements Identified During the Audit

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- AU-C section 260, *The Auditor's Communication With Those Charged With Governance*
- AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- AU-C section 320, *Materiality in Planning and Performing the Audit*
- AU-C section 530, *Audit Sampling*
- AU-C section 580, *Written Representations*
- AU-C section 600, *Special Considerations —Audits of Group Financial Statements (Including the Work of Component Auditors)*
- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
- AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*

General

.01 Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and fair presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that

- misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users made on the basis of the financial statements.
- judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both.
- judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

.02 Such a discussion about materiality provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph .01 provide the auditor with such a frame of reference.

.03 The auditor's determination of materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users

- have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

- understand that financial statements are prepared, presented, and audited to levels of materiality;
- recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and
- make reasonable economic decisions on the basis of the information in the financial statements.

.04 The concept of materiality is applied by the auditor both in planning and performing the audit; evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements; and in forming the opinion in the auditor's report.

.05 In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for

a. determining the nature and extent of risk assessment procedures;

b. identifying and assessing the risks of material misstatement; and

c. determining the nature, timing, and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature (that is, qualitative considerations), the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

.06 *Audit risk* is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when

a. determining the nature and extent of risk assessment procedures to be performed;

b. identifying and assessing the risks of material misstatement;

c. determining the nature, timing, and extent of further audit procedures; and

d. evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

.07 The considerations of audit risk and materiality are affected by the size and complexity of the entity and the auditor's experience with and knowledge of the entity and its environment, including the entity's internal control. Certain entity related factors may also affect the nature, timing, and extent of further audit procedures with respect to relevant assertions related to specific account balances, classes of transactions, and disclosures.

.08 Additional discussion on audit risk is provided in section 3100, "Understanding the Assignment."

Auditor Requirements—Materiality

Determining Materiality and Performance Materiality When Planning the Audit

.09 When establishing the overall audit strategy, the auditor should determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, one or more particular classes of transactions, account balances, or disclosures exist for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users, then, taken on the basis of the financial statements, the auditor also should determine the materiality level or levels to be applied to those particular classes of transactions, account balances, or disclosures.

.10 The auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

.11 Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, or expenses)
- Whether items exist on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance, users may tend to focus on profit, revenue, or net assets)
- The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings)
- The relative volatility of the benchmark

.12 Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income, such as profit before tax, total revenue, gross profit, and total expenses; total equity; or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

.13 With regard to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions; the period-to-date financial results and financial position, budgets, or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition); and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

.14 Materiality relates to the financial statements that are being audited. When the financial statements are prepared for a financial reporting period of more or less than 12 months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.

.15 Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. A relationship exists between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider a percentage of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry. Chapter 3, "Planning and Performing Risk Assessment Procedures," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* provides further guidance about the use of benchmarks in determining materiality.

.16 *Considerations specific to smaller, less complex entities*. When an entity's profit before tax from continuing operations is consistently nominal, which might be the case for an owner-managed business in which the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances, or Disclosures

.17 Factors that may indicate the existence of one or more particular classes of transactions, account balances, or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

- Whether law, regulation, or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions and the remuneration of management and those charged with governance)
- The key disclosures with regard to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company)
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business)

.18 In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances, or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality

.19 Planning the audit solely to detect individual material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and leaves no margin for possible undetected misstatements. *Performance materiality* (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance, or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance, or disclosure exceeds the materiality level for that particular class of transactions, account balance, or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures, and the nature and extent of misstatements identified in previous audits and, thereby, the auditor's expectations regarding misstatements in the current period.

.20 AU-C section 320 defines *performance materiality* as

> The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, *performance materiality* also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Performance materiality is to be distinguished from tolerable misstatement.

.21 For example, suppose that for planning purposes the auditor determined materiality to be $100,000, and he or she designed his or her audit to obtain reasonable assurance that misstatements of that magnitude were detected. Because of the way the auditor designed his or her audit, he or she may not detect a misstatement of $80,000, which is acceptable because the amount is not considered material. However, what if the auditor failed to detect 2 misstatements of $80,000? Individually, each misstatement would not be material, but when aggregated, the total misstatement is greater than materiality. Thus, materiality for the financial statements as a whole would not be appropriate for assessing risk and performing further audit procedures at the assertion level.

.22 Performance materiality is the adjustment of financial statement materiality to the assertion level. This adjustment is necessary to make an allowance for misstatements that might arise in other accounts as well as make a provision for possible misstatements that might exist in the financial statements, but were not detected by the audit procedures. Performance materiality effectively creates a margin for error in the auditor's audit plan to take into consideration misstatements that are not detected as part of the audit.

.23 For each class of transactions, account balance, and disclosure, the auditor should determine at least one level of performance materiality. For example, if the auditor's overall financial statement materiality for audit planning purposes was $100,000, he or she might determine performance materiality for testing receivables to be $70,000. Some firms use a guideline of, for example, 50 percent to 75 percent of materiality when setting tolerable misstatement at the account or detailed level for the average audit situation. Appendix L, "Matters to Consider in Determining Performance Materiality," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* provides further guidance on this topic. The AICPA Audit Guide *Audit Sampling* also provides additional discussion on the relationship of performance materiality and tolerable misstatement.

Tolerable Misstatement

.24 Tolerable misstatement is the application of performance materiality to a particular sampling procedure. AU-C section 530 defines *tolerable misstatement* as "[a] monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population." AU-C section 530 also provides further application guidance about the concept.

.25 Tolerable misstatement may be the same amount or an amount smaller than performance materiality (for example, when the population from which the sample is selected is smaller than the account balance).

Revision as the Audit Progresses

.26 The auditor should revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

.27 In some situations, the auditor may determine materiality for planning purposes before the financial statements to be audited are prepared. In those situations, the auditor's professional judgment about materiality might be based on the entity's annualized interim financial statements or financial statements of one or more prior annual periods. If it appears as though the actual financial results are likely to be substantially different from the anticipated results, such as when there are major changes in the entity's circumstances (for example, a significant merger) or relevant changes in the economy as a whole or the industry in which the entity operates, the auditor may be required, in accordance with paragraph .12 of AU-C section 320, to revise materiality.

.28 Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if, during the audit, it appears as though actual financial results are likely to be substantially different from the anticipated period-end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor may be required, in accordance with paragraph .12 of AU-C section 320, to revise materiality.

.29 If the auditor concludes that a lower materiality than that initially determined for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances, or disclosures) is appropriate, the auditor should determine whether it is necessary to revise performance materiality and whether the nature, timing, and extent of the further audit procedures remain appropriate.

Quantifying Materiality

.30 Although no authoritative body has established specific guidelines for materiality, certain rules of thumb can be used in making a preliminary assessment of materiality.

.31 Generally, materiality guidelines are relative rather than absolute. In other words, materiality is usually set as a percentage rather than as an absolute amount. For example, an absolute amount such as $100,000 may be immaterial to a large, multinational corporation but very material to a small, closely held company. To apply percentage guidelines, auditors determine what base to use. Generally, auditors select a base that is relatively stable and predictable. Bases commonly used include income before taxes, revenues, and total assets. Generally, misstatements become material to income before they become material to the balance sheet. As a consequence, net income before taxes is often selected as the base.

.32 In small business audits, auditors sometimes make a number of significant audit adjustments. Thus, income before taxes may vary too much to be useful as a base. When income before taxes is not used as a base, auditors sometimes use either total revenue or an average of net income for several prior periods.

Example

.33 A common rule of thumb for materiality is 5 percent to 10 percent of pretax income (for profit-orientated entities). Some auditors apply this rule of thumb so that items less than 5 percent of normal pretax income are considered immaterial, whereas items that are more than 10 percent are material. For items between 5 percent and 10 percent, judgment is applied. For example, when unusual factors exist (perhaps the company is about to be sold for a multiple of audited earnings) auditors would tend to classify items between 5 percent and 10 percent as material. Others use 0.5 percent to 2 percent of total assets or revenues. Note that a percentage of pretax income may not be an appropriate benchmark for the determination of materiality when, for example, the entity's earnings are volatile, when the entity is a not-for-profit entity, or when the owner takes much of the pretax income out of the business in the form of remuneration. Ordinarily, once a basis for materiality has been determined, it does not change from one year to the next. See the following sample materiality worksheet.

Sample Materiality Worksheet

Client: ____

Audit Date: ____

Step 1: Identify the users of the financial statements:

Financial statement users	Identify the criteria that are important to the users. This should include specific financial statement line items or disclosures.
1)	
2)	
3)	

Step 2: Identify qualitative factors that should be considered:

Qualitative consideration	Possible impact to financial statements and/or audit procedures
1) *(i.e. Significant turnover in management)*	*(i.e. New members of management might not be familiar with historically complex estimates)*
2)	
3)	

Step 3: Calculate Overall Materiality
(this is the materiality for the financial statements as a whole)

Use professional judgment as to assess the highest amount of misstatement(s) that could be included in the financial statements without affecting the economic decisions made by users of the financial statements.

Type of entity	Basis for materiality	Current period	Prior period	Acceptable benchmark range per firm policy*	Determined rate**	Preliminary overall materiality	Comments
Profit-oriented	Income before taxes from continuing operations			*(i.e. 5% –10%)*			
	Gross revenue			*(i.e. 0.5% –2%)*			
	Other (describe)						
Not-for-profit	Total revenue or expenses			*(i.e. 0.5% –2%)*			
	Net assets available for spend (unrestricted and temporarily restricted net assets)			*(i.e. 2% –5%)*			
	Other (describe)						

** The ranges listed are for illustrative purposes only, they should be updated based on your firm's policies or practices.*
*** The rate used falls within the benchmark range. Document rationale if a rate outside of the benchmark range is used.*

(continued)

Sample Materiality Worksheet

Step 4: Calculate Performance Materiality
[used to reduce the risk that misstatement(s) could exceed overall materiality (as calculated above)]

The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Performance materiality is to be distinguished from tolerable misstatement.

Overall materiality from above	Acceptable benchmark range per firm policy*	Determined rate**	Preliminary overall materiality	Comments
	(i.e. 50%–75%)			

** The ranges listed are for illustrative purposes only, they should be updated based on your firm's policies or practices.*
*** The rate used falls within the benchmark range. Document rationale if a rate outside of the benchmark range is used.*

Step 5: Calculate Clearly Trivial Threshold

The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than the performance materiality and will be matters that are clearly inconsequential, whether taken individually or in the aggregate and whether judged by any criteria of size, nature, or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

Performance materiality from above	Acceptable benchmark range per firm policy*	Determined rate**	Clearly trivial threshold	Comments
	(i.e. 2%–5%)			

** The ranges listed are for illustrative purposes only, they should be updated based on your firm's policies or practices.*
*** The rate used falls within the benchmark range. Document rationale if a rate outside of the benchmark range is used.*

Step 6: Assess Specific Materiality Thresholds (if applicable)
(where considered necessary to address particular risks of misstatement in a class of transactions, account balance, or F/S disclosure)

If a specific materiality level is considered necessary for other financial statement areas or disclosures based on identified risks, provide the details on a supplementary workpaper that cross-references this form. Specific materiality thresholds are generally lower than performance materiality.

Financial statement line items, class of transactions, account balance, or F/S disclosure	Specific materiality threshold	Comments
1)		
2)		
3)		

Sample Materiality Worksheet
Step 7: Reassess Materiality Thresholds—Update if Necessary The auditor should revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

Consider the following:	**Yes/No If yes, reassess overall and performance materiality**	**Comments**		**Final overall materiality**	**Final performance materiality**
During the course of the audit, have there been any changes in operations/results that could affect materiality?					
During the course of the audit, has there been any new information obtained that could affect materiality?					
During the course of the audit, have any misstatements been identified that could affect materiality?					
During the course of the audit, has the auditor become aware of any other factors that could affect materiality?					

Step 8: Update the Audit Plan and Procedures (if necessary) If the auditor concludes that a lower materiality than that initially determined for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances, or disclosures) is appropriate, the auditor should determine whether it is necessary to revise performance materiality and whether the nature, timing, and extent of the further audit procedures remain appropriate.

Consider the following:	**Yes/No**	**Comments**
Has the impact of any revisions in overall and performance materiality been addressed in the risk assessments and in the nature, extent, and timing of further audit procedures required?		

Preliminary materiality levels			
Prepared by:	Date:	Reviewed by:	Date:
Update for final materiality levels			
Prepared by:	Date:	Reviewed by:	Date:

.34 Consideration of which base to use may include such factors as income variability and the nature of the client's business and industry. For a not-for-profit organization, for example, the auditor would probably use total expendable net assets (unrestricted and temporarily restricted) as a base because pretax income is not as meaningful to users of the financial statements.

Documentation

.35 The auditor should include in the audit documentation the following amounts and the factors considered in their determination:

a. Materiality for the financial statement as a whole

b. If applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures

c. Performance materiality

d. Any revision of *a–c* as the audit progressed

Nature and Causes of Misstatements

.36 Misstatements may result from errors or fraud, such as

- an inaccuracy in gathering or processing data from which financial statements are prepared,
- an omission of an amount or disclosure,
- a financial statement disclosure that is not presented in accordance with the applicable financial reporting framework,
- an incorrect accounting estimate arising from overlooking or clear misinterpretation of facts, and
- judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.

Other examples of misstatements arising from fraud are provided in paragraphs .A1–.A8 of AU-C section 240.

.37 The auditor's consideration of laws and regulations in a financial statement audit is defined in AU-C section 250. See section 3150, "Illegal Acts," of this manual. For those laws and regulations that are defined in that statement as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from non-compliance with such laws and regulations is the same as that for errors or fraud.

Auditor Requirements—Evaluating Misstatements Identified During the Audit

Accumulation of Identified Misstatements

.38 The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial.

.39 The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with AU-C section 320 and will be matters that are clearly inconsequential, whether taken individually or in the aggregate and whether judged by any criteria of size, nature, or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

.40 To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, the auditor may find it useful to distinguish between factual misstatements, judgmental misstatements, and projected misstatements, described as follows:

- *Factual misstatements* are misstatements about which there is no doubt.
- *Judgmental misstatements* are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate.
- *Projected misstatements* are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn. AU-C section 530 establishes requirements and provides guidance on the determination of projected misstatements and evaluation of the results.

Consideration of Identified Misstatements as the Audit Progresses

.41 The auditor should determine whether the overall audit strategy and audit plan need to be revised if

- the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or
- the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with AU-C section 320.

.42 A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, when the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

.43 If the aggregate of misstatements accumulated during the audit approaches materiality, a greater than acceptably low level of risk may exist that possible undetected misstatements, when taken with the aggregate of uncorrected misstatements accumulated during the audit, could exceed materiality. Undetected misstatements could exist because of the presence of sampling risk and nonsampling risk.

Communication and Correction of Misstatements

.44 The auditor should communicate on a timely basis with the appropriate level of management all misstatements accumulated during the audit. The auditor should request management to correct those misstatements.

.45 Timely communication of misstatements to the appropriate level of management is important because it enables management to evaluate whether the items are misstatements, inform the auditor if they disagree, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and take the necessary action.

.46 Law or regulation may restrict the auditor's communication of certain misstatements to management or others within the entity. For example, laws or regulations may specifically prohibit a communication or other action that might prejudice an investigation by an appropriate authority into an instance of non-compliance or suspected non-compliance with laws or regulations. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

.47 The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

.48 If, at the auditor's request, management has examined a class of transactions, account balance, or disclosure and corrected misstatements that were detected, the auditor should perform additional audit procedures to determine whether misstatements remain.

.49 The auditor may request management to examine a class of transactions, account balance, or disclosure in order for management to understand the cause of a misstatement identified by the auditor; perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance, or disclosure; and make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

.50 The auditor may request management to record an adjustment needed to correct all factual misstatements, including the effect of prior period misstatements, other than those that the auditor believes are clearly trivial.

.51 When the auditor has identified a judgmental misstatement involving differences in estimates, such as a difference in a fair value estimate, the auditor may request management to review the assumptions and methods used in developing management's estimate.

.52 If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

.53 AU-C section 700 requires the auditor to evaluate whether the financial statements are presented fairly, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments, which may be affected by the auditor's understanding of management's reasons for not making the corrections (see also paragraph .15 of AU-C section 700)

.54 AU-C section 580 establishes requirements and provides guidance regarding the auditor's responsibility to obtain written representations in an audit of financial statements from management and, when appropriate, those charged with governance, including representations with respect to uncorrected misstatements.

.55 In accordance with AU-C section 265 identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity's internal control is an indicator of a material weakness.

.56 AU-C section 260 establishes requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance, including matters to be communicated by the auditor to those charged with governance, which, among other items, includes uncorrected misstatements.

Evaluating the Effect of Uncorrected Misstatements

.57 Prior to evaluating the effect of uncorrected misstatements, the auditor should reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results.

.58 The auditor's determination of materiality in accordance with AU-C section 320 often is based on estimates of the entity's financial results because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with AU-C section 320 based on the actual financial results.

.59 AU-C section 320 explains that, as the audit progresses, materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances, or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with AU-C section 320 gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing, and extent of the further audit procedures are reconsidered in order to obtain sufficient appropriate audit evidence on which to base the audit opinion.

.60 Materiality is determined based on the auditor's understanding of the user needs and expectations. Although user expectations may differ based on inherent uncertainty associated with the measurement of particular items in the financial statements, these expectations have already been considered in the auditor's determination of materiality. For example, the fact that the financial statements include very large provisions with a high degree of estimation uncertainty (for example, provisions for insurance claims in the case of an insurance company; oil rig decommissioning costs in the case of an oil company; or, more generally, legal claims against an entity) may influence the auditor's assessment of what users might consider material. However, after materiality is reassessed, this section requires the auditor to evaluate any misstatements in accordance with that level of materiality, regardless of the degree of inherent uncertainty associated with the measurement of particular items in the financial statements.

.61 The auditor should determine whether uncorrected misstatements are material, individually or in the aggregate. In making this determination, the auditor should consider

a. the size and nature of the misstatements, both in relation to particular classes of transactions, account balances, or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence and

b. the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures and the financial statements as a whole.

.62 Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances, or disclosures, including whether the materiality level for that particular class of transactions, account balance, or disclosure, if any, has been exceeded.

.63 The auditor is required by AU-C section 600 to evaluate the effect on the group audit opinion of any uncorrected misstatement identified by the group engagement team or communicated by the component auditors. Additional guidance regarding uncorrected misstatements in group audits can be found in Technical Questions and Answers sections 8800.18, "Determining Component Materiality," and .23, "Use of Component Materiality When the Component Is Not Reported On Separately" (AICPA, *Technical Practice Aids*).

.64 If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate. The auditor may need to reassess the risks of material misstatement for a specific account balance or class of transactions upon identification of a number of immaterial misstatements within that account balance or class of transactions.

.65 Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or subtotals, or the effect on key ratios. Circumstances may exist in which the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

.66 The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement

- affects compliance with regulatory requirements.
- affects compliance with debt covenants or other contractual requirements.
- relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements.
- masks a change in earnings or other trends, especially in the context of general economic and industry conditions.
- affects ratios used to evaluate the entity's financial position, results of operations, or cash flows.
- affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability).
- has the effect of increasing management compensation (for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied).
- is significant with regard to the auditor's understanding of known previous communications to users (for example, regarding forecast earnings).
- relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management).
- is an omission of information not specifically required by the applicable financial reporting framework but that, in the professional judgment of the auditor, is important to the users' understanding of the financial position, financial performance, or cash flows of the entity.
- affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. AU-C section 720 addresses the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.
- is a misclassification between certain account balances affecting items disclosed separately in the financial statements (for example, misclassification between operating and nonoperating income or recurring and nonrecurring income items or a misclassification between restricted and unrestricted resources in a not-for-profit entity).
- offsets effects of individually significant but different misstatements.
- is currently immaterial and likely to have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.
- is too costly to correct. It may not be cost beneficial for the client to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management.
- represents a risk that possible additional undetected misstatements would affect the auditor's evaluation.
- changes a loss into income or vice versa.
- heightens the sensitivity of the circumstances surrounding the misstatement (for example, the implications of misstatements involving fraud and possible instances of non-compliance with laws or regulations, violations of contractual provisions, and conflicts of interest).

- has a significant effect relative to reasonable user needs (for example, [*a*] earnings to investors and the equity amounts to creditors, [*b*] the magnifying effects of a misstatement on the calculation of purchase price in a transfer of interests [buy-sell agreement], and [*c*] the effect of misstatements of earnings when contrasted with expectations).
- relates to the definitive character of the misstatement (for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty).
- indicates the motivation of management (for example, [*a*] an indication of a possible pattern of bias by management when developing and accumulating accounting estimates, [*b*] a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process, or [*c*] an intentional decision not to follow the applicable financial reporting framework).

These circumstances are only examples—not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

.67 AU-C section 240 explains how the implications of a misstatement that is, or may be, the result of fraud are required to be considered with regard to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

.68 The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. Different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements are available. Using the same evaluation approach provides consistency from period to period.

.69 Often overlooked is the consideration of misstatements detected in the prior year that affect the current year. For example, assume last year's aggregation of uncorrected misstatements included an item representing an overstatement of prepaid insurance and an understatement of insurance expense. This item would be included in the current year's aggregation of uncorrected misstatements because it affects the current year's insurance expense. Therefore, the auditor may review the prior year's aggregation of uncorrected misstatements for any items that may have an effect on the current year's financial statements.

Summarizing Misstatements

.70 Most firms prepare a summary of the uncorrected misstatements identified during the audit. This summary may be called the "Summary of Misstatements" or the "Summary of Possible Journal Entries" or other names. The summary presents known, likely, and prior period misstatements separately. The summary is used in evaluating the effect of uncorrected misstatements on the financial statements at the end of the audit.

.71 Some firms establish a predetermined dollar threshold below which misstatements need not be accumulated. This amount may be set so that any such misstatements, either individually, or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered.

Documentation

.72 The auditor should include in the audit documentation the following:

a. The amount below which misstatements would be regarded as clearly trivial

b. All misstatements accumulated during the audit and whether they have been corrected

c. The auditor's conclusion about whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion

.73 The auditor's documentation of uncorrected misstatements may take into account the following:

a. The consideration of the aggregate effect of uncorrected misstatements

b. The evaluation of whether the materiality level or levels for particular classes of transactions, account balances, or disclosures, if any, have been exceeded

c. The evaluation of the effect of uncorrected misstatements on key ratios or trends and compliance with legal, regulatory, and contractual requirements (for example, debt covenants)

[*The next page is 3291.*]

AAM Section 3145

Fraud

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 260, *The Auditor's Communication With Those Charged With Governance*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 450, *Evaluation of Misstatements Identified During the Audit*
- AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
- AU-C section 580, *Written Representations*
- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*

General

.01 According to paragraph .12 of AU-C section 200, the overall objectives of the auditor, in conducting an audit of financial statements, are to

a. obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and

b. report on the financial statements, and communicate as required by generally accepted auditing standards (GAAS), in accordance with the auditor's findings.

.02 An auditor's responsibilities relating to fraud are stated within the context of materiality to the financial statements as a whole. An auditor is not responsible for detecting fraud per se, but for obtaining reasonable assurance that material misstatements due to fraud are detected. An auditor is not responsible for detecting immaterial misstatements caused by fraud.

.03 AU-C section 240 addresses the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, AU-C section 240 expands how AU-C sections 315 and 330 are to be applied regarding risks of material misstatement due to fraud.

.04 AU-C section 240 describes a process in which the auditor

- maintains professional skepticism,
- discusses the risks of material misstatements due to fraud with key engagement team members, including the engagement partner,

- gathers information needed to identify risks of material misstatement due to fraud,
- identifies the risks of material misstatement due to fraud,
- assesses the identified risks of material misstatement due to fraud after understanding the entity's related controls, including control activities, relevant to such risks,
- responds to the assessed risks of material misstatement due to fraud,
- evaluates audit evidence,
- communicates about fraud to management and those charged with governance, regulators, and others, and
- documents the auditor's understanding of the entity and its environment, the auditor's consideration of fraud, and communications about fraud to management, those charged with governance, regulators, and others.

.05 An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether caused by fraud or error. Accordingly, the auditor is primarily concerned with fraud that causes a material misstatement of the financial statements. However, in conducting the audit, the auditor may identify misstatements arising from fraud that are not material to the financial statements. Paragraphs .35–.36 and .39–.42 of AU-C section 240 address the auditor's responsibilities in such circumstances in evaluating audit evidence and in communicating audit findings, respectively.

.06 Intent is often difficult to determine, particularly in matters involving accounting estimates and the application of accounting principles. For example, unreasonable accounting estimates may be unintentional or may be the result of an intentional attempt to misstate the financial statements. Although an audit is not designed to determine intent, the auditor's objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

.07 According to AU-C section 240, the objectives of the auditor are to

a. identify and assess the risks of material misstatement of the financial statements due to fraud;

b. obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

c. respond appropriately to fraud or suspected fraud identified during the audit.

.08 Even though some requirements and guidance set forth in AU-C section 240 are presented in a manner that suggests a sequential audit process, auditing, in fact, involves a continuous process of gathering, updating, and analyzing information throughout the audit. Accordingly, the sequence of the requirements and guidance in AU-C section 240 may be implemented differently among audit engagements.

Description and Characteristics of Fraud

.09 The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Paragraph .11 of AU-C section 240 defines fraud as [a]n intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.

.10 Although fraud is a broad legal concept, for the purposes of GAAS, the auditor is primarily concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

.11 Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so, and some rationalization of the act, as follows:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps, unrealistic) earnings target or financial outcome—particularly because the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets (for example, because the individuals are living beyond their means).
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden (for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control).
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character, or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

Misstatements Arising From Fraudulent Financial Reporting

.12 Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions about the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

.13 Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

.14 Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as the following:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances
- Omitting, advancing, or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements

- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity
- Altering records and terms related to significant and unusual transactions

Misstatements Arising From Misappropriation of Assets

.15 Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management, who is usually better able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including the following:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts from written-off accounts to personal bank accounts)
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, or colluding with a competitor by disclosing technological data in return for payment)
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for approving payment at inflated prices, or payments to fictitious employees)
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party)

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

Responsibility for the Prevention and Detection of Fraud

.16 The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, places a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior, which can be reinforced by active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of financial statement users regarding the entity's performance and profitability.

Responsibilities of the Auditor

.17 An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. Due to the inherent limitations of an audit, an unavoidable risk exists that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS.

.18 As described in AU-C section 200 the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud.

.19 The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. Although the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas, such as accounting estimates, are caused by fraud or error.

.20 Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information, or override control procedures designed to prevent similar frauds by other employees.

.21 When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls, and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this section are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Auditor Requirements

Professional Skepticism

.22 In accordance with AU-C section 200, the auditor should maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.

.23 Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance when relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

.24 Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

.25 Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor should investigate further.

.26 An audit performed in accordance with GAAS rarely involves the authentication of documents, nor is the auditor trained as, or expected to be, an expert in such authentication. However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic, that terms in a document have been modified but not disclosed to the auditor, or that undisclosed side agreements may exist, possible procedures to investigate further may include

- confirming directly with the third party.
- using the work of a specialist to assess the document's authenticity.

.27 The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud:

- Discrepancies in the accounting records, including the following:
    - Transactions that are not recorded in a complete or timely manner or are improperly recorded by amount, accounting period, classification, or entity policy
    - Unsupported or unauthorized balances or transactions
    - Last minute adjustments that significantly affect financial results
    - Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties
    - Tips or complaints to the auditor about alleged fraud
- Conflicting or missing evidence, including the following:
    - Missing documents
    - Documents that appear to have been altered
    - Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist
    - Significant unexplained items on reconciliations
    - Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships; for example, receivables growing faster than revenues
    - Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures
    - Unusual discrepancies between the entity's records and confirmation replies
    - Large numbers of credit entries and other adjustments made to accounts receivable records
    - Unexplained or inadequately explained differences between the accounts receivable subledger and the control account, or between the customer statements and the accounts receivable subledger
    - Missing or nonexistent cancelled checks in circumstances in which cancelled checks are ordinarily returned to the entity with the bank statement
    - Missing inventory or physical assets of significant magnitude
    - Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies
    - Fewer responses to confirmations than anticipated or a greater number of responses than anticipated
    - Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments
- Conditions relating to governmental entities or not-for-profit organizations:
    - Significant transfers or transactions between funds or programs, or both, lacking supporting documents
    - Abnormal budget conditions, such as the following:
        - Significant budget adjustments
        - Requests for additional funding
        - Budget adjustments made without approval
        - Large amounts of over-or-under spending
        - Programs with an emphasis on spending money quickly

- — Procurement conditions, such as the following:
  - Lack of procurement legislation
  - Recent changes to procurement legislation
  - Complex or unclear legislation
  - Involvement of significant monetary amounts (such as in the defense area)
  - Investigation by regulatory authorities
  - Complaints received from potential suppliers about questionable practices related to awarding of contracts
  - Former governmental officials functioning as executives of companies to which contracts have been awarded
- — Program conditions, such as the following:
  - Newly implemented programs without existing management and accountability structures
  - Programs established for political purposes
  - Programs established to deal with an immediate emergency or crisis
  - Programs experiencing unusual growth due to conditions beyond the control of management
- — Grant and donor funding conditions, such as the following:
  - Non-compliance with grant requirements
  - Unclear grant requirements
  - Grants not reaching the intended recipient
  - Complaints from intended recipients or interest groups, and lack of monitoring of grantee compliance with applicable law or regulation

- Problematic or unusual relationships between the auditor and management, including the following:
  - — Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought
  - — Undue time pressures imposed by management to resolve complex or contentious issues
  - — Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management
  - — Unusual delays by the entity in providing requested information
  - — Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques
  - — Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel
  - — An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable
  - — An unwillingness to address identified deficiencies in internal control on a timely basis

- Other circumstances, including the following:
  - — Unwillingness by management to permit the auditor to meet privately with those charged with governance
  - — Accounting policies that appear to be at variance with industry norms
  - — Frequent changes in accounting estimates that do not appear to result from changed circumstances
  - — Tolerance of violations of the entity's code of conduct

.28 When responses to inquiries of management, those charged with governance, or others are inconsistent or otherwise unsatisfactory (for example, vague or implausible), the auditor should further investigate the inconsistencies or unsatisfactory responses.

Discussion Among the Engagement Team

.29 AU-C section 315 requires a discussion among the key engagement team members, including the engagement partner, and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion should include an exchange of ideas or brainstorming among the engagement team members about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. The discussion should occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity, and should, in particular, also address

a. known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud;

b. the risk of management override of controls;

c. consideration of circumstances that might be indicative of earnings management or manipulation of other financial measures and the practices that might be followed by management to manage earnings or other financial measures that could lead to fraudulent financial reporting;

d. the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud; and

e. how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud.

Communication among the engagement team members about the risks of material misstatement due to fraud should continue throughout the audit, particularly upon discovery of new facts during the audit.

.30 Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team

- provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention during the audit.

.31 The discussion may lead to a thorough probing of the issues, acquiring of additional evidence as necessary, and consulting with other team members and, if appropriate, specialists in or outside the firm. The discussion may include the following matters:

- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees that have come to the attention of the engagement team
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud
- A consideration of how an element of unpredictability will be incorporated into the nature, timing, and extent of the audit procedures to be performed
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statements to material misstatement due to fraud and whether certain types of audit procedures are more effective than others
- A consideration of any allegations of fraud that have come to the auditor's attention

A number of factors may influence the extent of the discussion and how it may occur. For example, if the audit involves more than one location, there could be multiple discussions with team members in differing locations. Another factor in planning the discussions is whether to include specialists assigned to the audit team.

.32 As previously noted in section 3120, "Obtaining an Understanding of the Entity and Its Environment," the brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session to discuss the potential of the risks of material misstatement that is required under AU-C section 315.

Risk Assessment Procedures and Related Activities

.33 When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by AU-C section 315, the auditor should perform the procedures in paragraphs .17–.24 of AU-C section 315 to obtain information for use in identifying the risks of material misstatement due to fraud.

Discussions With Management and Others Within the Entity

.34 The auditor should make inquiries of management regarding

a. management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent, and frequency of such assessments;

b. management's process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;

c. management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

d. management's communication, if any, to employees regarding its views on business practices and ethical behavior.

.35 Management accepts responsibility for the entity's internal control and for the preparation and fair presentation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent, and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent, and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may, in some circumstances, be indicative of the lack of importance that management places on internal control.

.36 *Considerations specific to smaller, less complex entities*. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

.37 In the case of entities with multiple locations, management's processes may include different levels of monitoring of operating locations or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

.38 The auditor should make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity.

.39 Inquiries of management and others within the entity are generally most effective when they involve an in-person discussion. The auditor may also determine it useful to provide the interviewee with specific questions and obtain written responses in advance of the discussion.

.40 The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity, in addition to management, may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated. It may be useful in providing the auditor with a perspective that is different from that of individuals in the financial reporting process. The responses to these other inquiries might serve to corroborate responses received from management or, alternatively, might provide information regarding the possibility of management override of controls. The auditor may also obtain information about how effectively management has communicated standards of ethical behavior throughout the organization.

.41 Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include the following:

- Operating personnel not directly involved in the financial reporting process
- Employees with different levels of authority
- Employees involved in initiating, processing, or recording complex or unusual transactions and those who supervise or monitor such employees
- In-house legal counsel
- Chief ethics officer or equivalent person
- The person or persons charged with dealing with allegations of fraud

.42 Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

.43 For those entities that have an internal audit function, the auditor should make inquiries of internal audit to obtain its views about the risks of fraud; determine whether it has knowledge of any actual, suspected, or alleged fraud affecting the entity; whether it has performed any procedures to identify or detect fraud during the year; and whether management has satisfactorily responded to any findings resulting from these procedures.

Those Charged With Governance

.44 Unless all of those charged with governance are involved in managing the entity, the auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.

.45 Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control, and compliance with the law. In some circumstances, governance practices are well developed, and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Because the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands the respective responsibilities of those charged with governance and management to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.

.46 An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings during which such discussions take place, reading the minutes from such meetings, or making inquiries of those charged with governance.

.47 *Considerations specific to smaller, less complex entities*. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity in which a single owner manages the entity, and no one else has a governance role. In these cases, ordinarily, no action exists on the part of the auditor because no oversight exists separate from management.

.48 Unless all of those charged with governance are involved in managing the entity, the auditor should make inquiries of those charged with governance (or the audit committee or, at least, its chair) to determine their views about the risks of fraud and whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity. These inquiries are made, in part, to corroborate the responses received from the inquiries of management.

Unusual or Unexpected Relationships Identified

.49 Based on analytical procedures performed as part of risk assessment procedures, the auditor should evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatement due to fraud. To the extent not already included, the analytical procedures, and evaluation thereof, should include procedures relating to revenue accounts.

.50 Analytical procedures may include data analysis techniques ranging from a high-level review of data patterns, relationships, and trends to highly sophisticated, computer-assisted investigation of detailed transactions using electronic tools, such as data mining, business intelligence, and file query tools. The degree of reliance that can be placed on such techniques is a function primarily of the source (for example, financial, nonfinancial), completeness and reliability of the data, the level of disaggregation, and the nature of the analysis.

.51 Analytical procedures relating to revenue that are performed with the objective of identifying unusual or unexpected relationships that may indicate a material misstatement due to fraudulent financial reporting may include

a. a comparison of sales volume, as determined from recorded revenue amounts, with production capacity. An excess of sales volume over production capacity may be indicative of recording fictitious sales.

b. a trend analysis of revenues by month and sales returns by month, during and shortly after the reporting period. This may indicate the existence of undisclosed side agreements with customers involving the return of goods, which, if known, would preclude revenue recognition.

c. a trend analysis of sales by month compared with units shipped. This may identify a material misstatement of recorded revenues.

.52 Analytical procedures performed during planning may be helpful in identifying the risks of material misstatement due to fraud. However, if such analytical procedures use data aggregated at a high level, generally the results of those analytical procedures provide only a broad initial indication about whether a material misstatement of the financial statements may exist. Accordingly, the results of analytical procedures performed during planning may be considered along with other information gathered by the auditor in identifying the risks of material misstatement due to fraud.

Other Information

.53 The auditor should consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud.

.54 In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

Evaluation of Fraud Risk Factors

.55 The auditor should evaluate whether the information obtained from the risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. Although fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances in which frauds have occurred and, therefore, may indicate risks of material misstatement due to fraud.

.56 The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors), such as the following:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud.
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud.
- A control environment that is not effective may create an opportunity to commit fraud.

.57 Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities in which the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

.58 Fraud risk factors are events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action.

.59 Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in the following two paragraphs. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud
- A perceived opportunity to commit fraud
- An ability to rationalize the fraudulent action

The inability to observe one or more of these conditions does not necessarily mean that no risk of material misstatement due to fraud exists.

.60 Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in the following two paragraphs cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting

.61 The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives and Pressures

.62 Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:

- High degree of competition or market saturation, accompanied by declining margins
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- Significant declines in customer demand and increasing business failures in either the industry or overall economy
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry
- New accounting, statutory, or regulatory requirements

.63 Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages
- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards
- A need to achieve financial targets required in bond covenants
- Pressure for management to meet the expectations of legislative or oversight bodies or to achieve political outcomes, or both

.64 Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow[1]
- Personal guarantees of debts of the entity

.65 Management or operating personnel are under excessive pressure to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

.66 The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
- Significant operations located or conducted across jurisdictional borders where differing business environments and regulations exist
- Use of business intermediaries for which there appears to be no clear business justification
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification

.67 The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non-owner-managed business) without compensating controls
- Oversight by those charged with governance over the financial reporting process and internal control is not effective

.68 The organizational structure is complex or unstable, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
- High turnover of senior management, legal counsel, or those charged with governance

.69 Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (when external reporting is required)

[1] Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

- High turnover rates or employment of accounting, internal audit, or IT staff who are not effective
- Accounting and information systems that are not effective, including situations involving significant deficiencies or material weaknesses in internal control
- Weak controls over budget preparation and development and compliance with law or regulation

Attitudes and Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards that are not effective
- Nonfinancial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates
- Known history of violations of securities law or other law or regulation, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of law or regulation
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts
- Management failing to remedy known significant deficiencies or material weaknesses in internal control on a timely basis
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons
- Low morale among senior management
- The owner-manager makes no distinction between personal and business transactions
- Dispute between shareholders in a closely held entity
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
- A strained relationship between management and the current or predecessor auditor, as exhibited by the following:
  - — Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
  - — Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report
  - — Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance
  - — Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

Risk Factors Arising From Misstatements Arising From Misappropriation of Assets

.70 The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives and Pressures

.71 Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

.72 Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs
- Recent or anticipated changes to employee compensation or benefit plans
- Promotions, compensation, or other rewards inconsistent with expectations

Opportunities

.73 Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when the following exist:

- Large amounts of cash on hand or processed
- Inventory items that are small in size, of high value, or in high demand
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips
- Fixed assets that are small in size, marketable, or lack observable identification of ownership

.74 Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because the following exist:

- Inadequate segregation of duties or independent checks
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements
- Inadequate management oversight of employees responsible for assets (for example, inadequate supervision or monitoring of remote locations)
- Inadequate job applicant screening of employees with access to assets
- Inadequate record keeping with respect to assets
- Inadequate system of authorization and approval of transactions (for example, in purchasing)
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets
- Lack of complete and timely reconciliations of assets
- Lack of timely and appropriate documentation of transactions (for example, credits for merchandise returns)
- Lack of mandatory vacations for employees performing key control functions
- Inadequate management understanding of IT, which enables IT employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer systems event logs

Attitudes and Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee

- Changes in behavior or lifestyle that may indicate assets have been misappropriated
- The belief by some government or other officials that their level of authority justifies a certain level of compensation and personal privileges
- Tolerance of petty theft

.75 The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as

- effective oversight by those charged with governance.
- an effective internal audit function.
- the existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

.76 *Considerations specific to smaller, less complex entities*. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control because an opportunity exists for management override of controls.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

.77 In accordance with AU-C section 315, the auditor should identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures. The auditor's risk assessment should be ongoing throughout the audit, following the initial assessment.

Risks of Fraud in Revenue Recognition

.78 When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks. Paragraph .46 of AU-C section 240 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud.

.79 Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.

.80 The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition when, for example, performance is measured in terms of year over year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

.81 The presumption that risks of fraud exist in revenue recognition may be rebutted. For example, the auditor may conclude that no risk of material misstatement due to fraud relating to revenue recognition exists in the case in which a single type of simple revenue transaction exists, for example, leasehold revenue from a single unit rental property.

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls

.82 The auditor should treat those assessed risks of material misstatement due to fraud as significant risks and, accordingly, to the extent not already done so, the auditor should obtain an understanding of the entity's related controls, including control activities, relevant to such risks, including the evaluation of whether such controls have been suitably designed and implemented to mitigate such fraud risks.

.83 Management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

.84 It is, therefore, important for the auditor to obtain an understanding of the controls that management has designed, implemented, and maintained to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

.85 The auditing procedures performed in response to identified risks of material misstatement due to fraud will vary depending on the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected. These procedures may involve both substantive tests and tests of the operating effectiveness of the entity's programs and controls.

.86 In accordance with AU-C section 330, the auditor should determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.

.87 Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism through, for example, increased

- sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- recognition of the need to corroborate management explanations or representations concerning material matters.

Determining overall responses to address the assessed risks of material misstatement due to fraud also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph .29 of AU-C section 240 (discussed in the following paragraph).

.88 In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor should *a.* assign and supervise personnel, taking into account the knowledge, skill, and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement;

b. evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings, or a bias that may create a material misstatement; and

c. incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures.

.89 *Assignment and supervision of personnel*. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT specialists, or by assigning more experienced individuals to the engagement.

.90 The extent of supervision reflects the auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.

.91 *Accounting principles*. Management bias in the selection and application of accounting principles may individually or collectively involve matters such as contingencies, fair value measurements, revenue recognition, accounting estimates, related party transactions, or other transactions without a clear business purpose.

.92 *Unpredictability in the selection of audit procedures*. Incorporating an element of unpredictability in the selection of the nature, timing, and extent of audit procedures to be performed is important because individuals within the entity who are familiar with the audit procedures normally performed on engagements may be better able to conceal fraudulent financial reporting. This can be achieved by, for example,

- performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
- adjusting the timing of audit procedures from that otherwise expected.
- using different sampling methods.
- performing audit procedures at different locations or at locations on an unannounced basis.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

.93 In accordance with AU-C section 330, the auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.

.94 The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. For example:
  - — Physical observation or inspection of certain assets may become more important, or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.
  - — The auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external

confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return, and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of nonfinancial personnel in the entity regarding any changes in sales agreements and delivery terms.

- The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement—for example, a misstatement involving improper revenue recognition—may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.
- The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

.95 If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date.

.96 The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions. These may include asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of segments of the business), and other significant accrued liabilities (such as pension and other postemployment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

.97 The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly, they may not be the most appropriate nor necessary in each circumstance. The order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures, and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis (for example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis)
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period

- Altering the audit approach in the current year (for example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information)
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear to have an unusual nature or amount
- For significant and unusual transactions, particularly those occurring at or near year end, investigating the possibility of related parties and the sources of financial resources supporting the transactions
- Performing substantive analytical procedures using disaggregated data (for example, comparing sales and cost of sales by location, line of business, or month to expectations developed by the auditor)
- Conducting interviews of personnel involved in areas in which a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk, and whether, or how, controls address the risk
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions, or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods, or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population
- Testing the integrity of computer-produced records and transactions
- Seeking additional audit evidence from sources outside of the entity being audited

Specific Responses—Misstatement Resulting From Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

Revenue Recognition	• Performing substantive analytical procedures relating to revenue using disaggregated data; for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods or with revenue related to cash collections (computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions)

(continued)

	• Confirming with customers certain relevant contract terms and the absence of side agreements because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented (for example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances) • Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions • Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures • For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded
Inventory Quantities	• Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count • Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date • Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period • Performing additional procedures during the observation of the count; for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals (using the work of an expert may be helpful in this regard) • Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records • Using computer-assisted audit techniques to further test the compilation of the physical inventory counts (for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication)
Management Estimates	• Using an expert to develop an independent estimate for comparison to management's estimate • Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate

Specific Responses—Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the preceding two categories may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year end
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit
- Analyzing recoveries of written-off accounts
- Analyzing inventory shortages by location or product type
- Comparing key inventory ratios to industry norm
- Reviewing supporting documentation for reductions to the perpetual inventory records
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers, or bank accounts
- Reviewing personnel files for those that contain little or no evidence of activity; for example, lack of performance evaluations
- Analyzing sales discounts and returns for unusual patterns or trends
- Confirming specific terms of contracts with third parties
- Obtaining evidence that contracts are being carried out in accordance with their terms
- Reviewing the propriety of large and unusual expenses
- Reviewing the authorization and carrying value of senior management and related party loans
- Reviewing the level and propriety of expense reports submitted by senior management

Audit Procedures Responsive to Risks Related to Management Override of Controls

.98 Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is, nevertheless, present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and, thus, a significant risk.

.99 Even if specific risks of material misstatement due to fraud are not identified by the auditor, a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing audit procedures to

a. test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to financial statement drafts. In designing and performing audit procedures for such tests, the auditor should

   i. obtain an understanding of the entity's financial reporting process and controls over journal entries and other adjustments, and the suitability of design and implementation of such controls;

ii. make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

iii. consider fraud risk indicators, the nature and complexity of accounts, and entries processed outside the normal course of business;

iv. select journal entries and other adjustments made at the end of a reporting period; and

v. consider the need to test journal entries and other adjustments throughout the period.

b. review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor should

i. evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor should reevaluate the accounting estimates taken as a whole, and

ii. perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year. Estimates selected for review should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management.

c. evaluate, for significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

.100 *Journal entries and other adjustments*. Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by (*a*) recording inappropriate or unauthorized journal entries throughout the year or at period end, or (*b*) making adjustments to amounts reported in the financial statements that are not reflected in formal journal entries, such as through consolidating adjustments, report combinations, and reclassifications.

.101 The auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important because automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

.102 When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters may be relevant:

- *The assessment of the risks of material misstatement due to fraud*. The presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
- *Controls that have been implemented over journal entries and other adjustments*. Effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
- *The entity's financial reporting process and the nature of evidence that can be obtained*. For many entities, routine processing of transactions involves a combination of manual and automated steps and

procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When IT is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.

- *The characteristics of fraudulent journal entries or other adjustments*. Inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (*a*) made to unrelated, unusual, or seldom-used accounts; (*b*) made by individuals who typically do not make journal entries; (*c*) recorded at the end of the period or as post-closing entries that have little or no explanation or description; (*d*) made either before or during the preparation of the financial statements that do not have account numbers; or (*e*) containing round numbers or consistent ending numbers.
- *The nature and complexity of the accounts*. Inappropriate journal entries or adjustments may be applied to accounts that (*a*) contain transactions that are complex or unusual in nature, (*b*) contain significant estimates and period-end adjustments, (*c*) have been prone to misstatements in the past, (*d*) have not been reconciled on a timely basis or contain unreconciled differences, (*e*) contain intercompany transactions, or (*f*) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.
- *Journal entries or other adjustments processed outside the normal course of business*. Nonstandard journal entries, and other entries such as consolidating adjustments, may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements.

.103 The auditor exercises professional judgment in determining the nature, timing, and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph .32*a*(iv) of AU-C section 240 requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph .32*a*(v) of AU-C section 240 requires the auditor to consider whether a need also exists to test journal entries and other adjustments throughout the period.

.104 *Accounting estimates*. The preparation and fair presentation of the financial statements requires management to make a number of judgments or assumptions that affect significant accounting estimates and monitor the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions about the entity's performance and profitability.

.105 The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether an indication exists of a possible bias on the part of management. This review is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

.106 A retrospective review is also required by AU-C section 540. That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management's prior period estimation process, audit evidence about the outcome, or when applicable, the subsequent re-estimation of prior period accounting estimates that is pertinent to making current period accounting estimates, and audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements. As a practical matter, the auditor's review of management judgments and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with this section may be carried out in conjunction with the review required by AU-C section 540.

.107 *Business rationale for significant transactions*. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include the following:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and inadequate documentation exists.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve nonconsolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- Transactions that involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Other Audit Procedures

.108 The auditor should determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to previously (that is, when specific additional risks of management override exist that are not covered as part of the procedures performed to address the requirements in paragraph .32 of AU-C section 240.

.109 Risks of material misstatement, including misstatements due to fraud, cannot be reduced to an appropriately low level by performing only tests of controls.

Evaluation of Audit Evidence

.110 AU-C section 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate. This evaluation is primarily a qualitative matter based on the auditor's professional judgment. Such an evaluation may provide further insight into the risks of material misstatement due to fraud and whether a need exists to perform additional or different audit procedures. Appendix C, "Examples of Circumstances That Indicate the Possibility of Fraud," of AU-C section 240 contains examples of circumstances that may indicate the possibility of fraud (included in paragraph .27).

.111 The auditor should evaluate, at or near the end of the audit, whether the accumulated results of auditing procedures (including analytical procedures that were performed as substantive tests or when forming an overall conclusion) affect the assessment of the risks of material misstatement due to fraud made earlier in the audit or indicate a previously unrecognized risk of material misstatement due to fraud. If not already performed when forming an overall conclusion, the analytical procedures relating to revenue, required by paragraph .22 of AU-C section 240, should be performed through the end of the reporting period.

Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion

.112 Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example, uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions or income that is inconsistent with trends in cash flow from operations.

.113 Some unusual or unexpected analytical relationships may have been identified and may indicate a risk of material misstatement due to fraud because management or employees generally are unable to manipulate certain information to create seemingly normal or expected relationships. Some examples are as follows:

- The relationship of net income to cash flows from operations may appear unusual because management recorded fictitious revenues and receivables but was unable to manipulate cash.
- Changes in inventory, accounts payable, sales, or cost of sales from the prior period to the current period may be inconsistent, indicating a possible employee theft of inventory, because the employee was unable to manipulate all of the related accounts.
- A comparison of the entity's profitability to industry trends, which management cannot manipulate, may indicate trends or differences for further consideration when identifying risks of material misstatement due to fraud.
- A comparison of bad debt write-offs to comparable industry data, which employees cannot manipulate, may provide unexplained relationships that could indicate a possible theft of cash receipts.
- An unexpected or unexplained relationship between sales volume, as determined from the accounting records and production statistics maintained by operations personnel, which may be more difficult for management to manipulate, may indicate a possible misstatement of sales.

.114 If the auditor identifies a misstatement, the auditor should evaluate whether such a misstatement is indicative of fraud. If such an indication exists, the auditor should evaluate the implications of the misstatement with regard to other aspects of the audit, particularly the auditor's evaluation of materiality, management and employee integrity, and the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence.

.115 If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is, or may be, the result of fraud and that management (in particular, senior management) is involved, the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures to respond to the assessed risks. The auditor should also consider whether circumstances or conditions indicate possible collusion involving employees, management, or third parties when reconsidering the reliability of evidence previously obtained.

.116 If the auditor concludes that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should evaluate the implications for the audit.

Consideration of Identified Misstatements

.117 Because fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so, or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

.118 The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question because there may be doubts about the completeness and truthfulness of representations made and the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management, or third parties.

.119 AU-C section 450 addresses the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

.120 AU-C section 580 addresses obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that, irrespective of the size of the entity, management acknowledges its responsibility for internal control designed, implemented, and maintained to prevent and detect fraud.

Auditor Unable to Continue the Engagement

.121 If, as a result of identified fraud or suspected fraud, the auditor encounters circumstances that bring into question the auditor's ability to continue performing the audit, the auditor should

a. determine the professional and legal responsibilities applicable in the circumstances, including whether a requirement exists for the auditor to report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities;

b. consider whether it is appropriate to withdraw from the engagement, when withdrawal is possible under applicable law or regulation; and

c. if the auditor withdraws

   i. discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal, and

   ii. determine whether a professional or legal requirement exists to report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

.122 Examples of circumstances that may arise and bring into question the auditor's ability to continue performing the audit include the following:

a. The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements.

b. The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud.

c. The auditor has significant concern about the competence or integrity of management or those charged with governance.

.123 Because of the variety of circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

.124 The auditor has professional and legal responsibilities in such circumstances, and these responsibilities may vary by engagement. In some circumstances, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who engaged the auditor or, in some cases, to regulatory authorities. Given the nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to regulators or others.

Communications to Management and With Those Charged With Governance

Communication to Management

.125 If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor should communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

.126 When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is true even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

Communication With Those Charged With Governance

.127 Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving

a. management,

b. employees who have significant roles in internal control, or

c. others, when the fraud results in a material misstatement in the financial statements,

the auditor should communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor should communicate these suspicions to those charged with governance and discuss with them the nature, timing, and extent of audit procedures necessary to complete the audit.

.128 The auditor's communication with those charged with governance may be made orally or in writing. AU-C section 260 identifies factors the auditor considers in determining whether to communicate orally or in writing. Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor communicates such matters on a timely basis and may consider it necessary to also communicate such matters in writing.

.129 In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

.130 When the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

Other Matters Related to Fraud

.131 The auditor should communicate with those charged with governance any other matters related to fraud that are, in the auditor's professional judgment, relevant to their responsibilities.

.132 Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example

- concerns about the nature, extent, and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- a failure by management to appropriately address identified significant deficiencies or material weaknesses in internal control, or to appropriately respond to an identified fraud.
- the auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort

to manage earnings in order to deceive financial statement users by influencing their perceptions concerning the entity's performance and profitability.

- concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.
- the absence of programs or controls to address risks of material misstatement due to fraud that are significant deficiencies or material weaknesses.

Communications to Regulatory and Enforcement Authorities

.133 If the auditor has identified or suspects a fraud, the auditor should determine whether the auditor has a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances.

.134 The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, in certain circumstances, the duty of confidentiality may be overridden by statute, regulation, courts of law, specific requirements of audits of entities that receive government financial assistance, or waived by agreement. In some circumstances, the auditor has a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some circumstances, the auditor has a duty to report misstatements to authorities in those cases when management and those charged with governance fail to take corrective action.

.135 The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

Documentation

.136 The auditor should include in the audit documentation of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by AU-C section 315 the following:

a. The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, and how and when the discussion occurred and the audit team members who participated

b. The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level

.137 The auditor should include in the audit documentation of the auditor's responses to the assessed risks of material misstatement required by AU-C section 330 the following:

a. The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing, and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level

b. The results of the audit procedures, including those designed to address the risk of management override of controls

.138 The auditor should include in the audit documentation communications about fraud made to management, those charged with governance, regulators, and others.

.139 If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is overcome in the circumstances of the engagement, the auditor should include in the audit documentation the reasons for that conclusion.

Fraud Risk Factor Considerations Listing

.140 An auditor may find this considerations listing helpful during planning and at other stages of the audit, when considering fraud risk factors and assessing the risks of material misstatement due to fraud. The listing contains example risk factors for small, privately owned businesses. If used, this listing should be tailored for the particular client being audited. Identified or possible risk factors should be added to the list. An auditor may also decide to remove the example factors from the list based on the circumstances. In any event, be sure to consider fraud risk factors that relate to fraudulent financial reporting and misappropriation of assets in every related category presented. An auditor should feel free to use this practice aid as he or she sees fit (for example, adding attachments, redesigning the form of the memory jogger). Finally, note that AU-C section 240 does not require an auditor to use a considerations listing or checklist for fraud risk factors.

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[2]	*Audit response documented? (W/P Ref.)*[3]	*Additional information*
Part 1—Fraudulent Financial Reporting				
A. Incentives and Pressures				
1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:				
a. High degree of competition or market saturation, accompanied by declining margins				
b. New accounting, statutory, or regulatory requirements				
c. Significant declines in customer demand and increasing business failures in either the industry or the economy in which the entity operates				
d. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates				
e. Operating losses making the threat of bankruptcy or foreclosure, imminent				
f. Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth				
g. Rapid growth or unusual profitability especially compared to that of other companies in the same industry				
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:				

(continued)

[2] Based on the assessment of risk of material misstatement due to fraud, an auditor may respond to identified risk factors individually or in combination.

[3] The auditor's response to identified risk factors should be included in the audit documentation. Generally, if a response is specific to a particular account balance or class of transactions, documentation of the audit procedures would be placed in the appropriate audit program (for example, cash investments). If it is determined that audit procedures already planned or normally carried out are a sufficient response to the identified risk factor, that fact should be documented.

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[2]	*Audit response documented? (W/P Ref.)*[3]	*Additional information*
a. Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures				
b. Marginal ability to meet debt repayment or other debt covenant requirements				
3. Management's personal net wealth is threatened by the entity's financial performance arising from the following:				
a. Heavy concentrations of their personal net worth in the entity.				
b. Personal guarantees of debt of the entity that are significant to their personal net worth.				
c. Adverse consequences on significant matters if *good* financial results are reported. Specific examples include management's motivation to inappropriately reduce income taxes, to defraud a divorced spouse or a partner of his or her share of the profits or assets of a business, or to convince a judge or arbitrator that the business in dispute is not capable of providing adequate cash flow. Keep in mind that you are not required to plan your audit to discover personal information (for example, marital status) of the owner-manager. However, if you become aware of such information, you may consider it in your assessment of risk of material misstatement due to fraud.				
4. There is excessive pressure on management or operating personnel to meet financial targets set by the owner, including sales or profitability incentive goals.				
B. Opportunities				
1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:				
a. Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm				
b. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate				

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[2]	*Audit response documented? (W/P Ref.)*[3]	*Additional information*
c. Significant, unusual, or highly complex transactions, especially those close to year-end that pose difficult "substance over form" questions				
2. There is a complex or unstable organizational structure as evidenced by the following:				
a. Difficulty in determining the organization or individuals that have controlling interest in the entity				
b. Overly complex organizational structure involving unusual legal entities or managerial lines of authority				
c. High turnover of senior management or counsel				
3. Internal control components are deficient as a result of the following:				
a. Inadequate monitoring of controls, including automated controls				
b. High turnover rates or employment of ineffective accounting staff.				
c. Ineffective accounting and information systems including situations involving reportable conditions				
C. Attitudes and Rationalizations				
1. A failure for management to display and communicate an appropriate attitude regarding internal control and the financial reporting process				
2. Ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards				
3. Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates				
4. Known history of violations or claims against the entity, its owner or senior management alleging fraud or violations of laws and regulations				
5. A practice by management of committing to creditors and other third parties to achieve aggressive or unrealistic forecasts				
6. Management failing to correct known reportable conditions on a timely basis				
7. An interest by management in employing inappropriate means to minimize reported earnings for tax motivated reasons				

(continued)

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[2]	*Audit response documented? (W/P Ref.)*[3]	*Additional information*
8. Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality				
9. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:				
a. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters				
b. Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report				
c. Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or those charged with governance				
d. Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of audit personnel assigned to the engagement				
Part 2—Misappropriation of Assets				
A. Incentives and Pressures				
1. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.				
2. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:				
a. Known or anticipated future layoffs				
b. Promotions, compensation, or other rewards inconsistent with expectations				
B. Opportunities				
1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:				
a. Large amounts of cash on hand or processed				

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[2]	*Audit response documented? (W/P Ref.)*[3]	*Additional information*
b. Company issued credit cards				
c. Inventory items that are small in size, of high value, or in high demand				
d. Easily convertible assets				
e. Fixed assets, that, are small in size, marketable, or lacking observable identification of ownership				
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:				
a. Inadequate segregation of duties or independent checks. Inadequate segregation of duties is quite often understandable in a small business environment in that it's a function of the entity's size. However, you may consider it in conjunction with other risk factors and with mitigating controls.				
b. Inadequate management oversight of employees responsible for assets.				
c. Inadequate job applicant screening of employees with access to assets.				
d. Inadequate record keeping with respect to assets.				
e. Inadequate system of authorization and approval of transactions (for example, in purchasing).				
f. Inadequate physical safeguards over cash, investments, inventory, or fixed assets.				
g. Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.				
h. Lack of mandatory vacations for employees performing key control functions.				
i. Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.				
j. Inadequate access controls over automated records.				
C. Attitudes and Rationalizations				
1. Disregard for the need for monitoring or reducing risks related to misappropriations of assets				

(continued)

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[2]	*Audit response documented? (W/P Ref.)*[3]	*Additional information*
2. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies				
3. Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee				
4. Changes in behavior or lifestyle that may indicate assets have been misappropriated				

[*The next page is 3311.*]

AAM Section 3150

Illegal Acts

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
- AU-C section 210, *Terms of Engagement*
- AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 580, *Written Representations*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

General Comments

.01 AU-C section 250 establishes requirements and provides guidance with respect to the auditor's responsibility to consider laws and regulations in an audit of financial statements.

.02 The effect on financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management, or set the provisions under which the entity is allowed to conduct its business, but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health and equal employment opportunity). Non-compliance with laws and regulations may result in fines, litigation, or other consequences for the entity that may have a material effect on the financial statements.

.03 The term *non-compliance* refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.

.04 Whether an act constitutes non-compliance with laws and regulations is a matter for legal determination, which ordinarily is beyond the auditor's professional competence to determine. Nevertheless, the auditor's training, experience, and understanding of the entity and its industry or sector may provide a basis to recognize that some acts coming to the auditor's attention may constitute non-compliance with laws and regulations.

Responsibility for Compliance With Laws and Regulations

Responsibility of Management

.05 Laws and regulations may affect an entity's financial statements in different ways (for example, most directly, they may affect specific disclosures required of the entity in the financial statements, or they may prescribe the applicable financial reporting framework). They also may establish certain legal rights and obligations of the entity, some of which will be recognized in the entity's financial statements. In addition, laws and regulations may provide for the imposition of penalties in cases of non-compliance.

.06 It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

.07 The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements
- Instituting and operating appropriate systems of internal control
- Developing, publicizing, and following a code of ethics or code of conduct
- Ensuring employees are properly trained and understand the code of ethics or code of conduct
- Monitoring compliance with the code of ethics or code of conduct and acting appropriately to discipline employees who fail to comply with it
- Engaging legal advisers to assist in monitoring legal requirements
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints

.08 In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function
- An audit committee
- A legal function
- A compliance function

Responsibility of the Auditor

.09 The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

.10 The auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Because of the inherent limitations of an audit, an unavoidable risk exists that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS. In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for the following reasons:

- Many laws and regulations relating principally to the operating aspects of an entity typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls, or intentional misrepresentations made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination, such as by a court of law.

Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of, or recognize, the non-compliance.

.11 AU-C section 250 distinguishes the auditor's responsibilities regarding compliance with the following two categories of laws and regulations:

a. The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations

b. The provisions of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be

i. fundamental to the operating aspects of the business,

ii. fundamental to an entity's ability to continue its business, or

iii. necessary for the entity to avoid material penalties

(for example, compliance with the terms of an operating license, regulatory solvency requirements, or environmental regulations); therefore, non-compliance with such laws and regulations may have a material effect on the financial statements.

Auditor Requirements Consideration of Compliance With Laws and Regulations

.12 As part of obtaining an understanding of the entity and its environment, in accordance with AU-C section 315 the auditor should obtain a general understanding of the following:

a. The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates

b. How the entity is complying with that framework

Obtaining an Understanding of the Legal and Regulatory Framework

.13 To obtain a general understanding of the legal and regulatory framework and how the entity complies with that framework, the auditor may, for example,

- use the auditor's existing understanding of the entity's industry and regulatory and other external factors;
- update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- inquire of management about other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations (including the prevention of non-compliance), if appropriate;

- inquire of management regarding the policies or procedures adopted for identifying, evaluating, and accounting for litigation claims;
- inquire of management regarding the use of directives issued by the entity and periodic representations obtained by the entity from management at appropriate levels of authority concerning compliance with laws and regulations; and
- consider the auditor's knowledge of the entity's history of non-compliance with laws and regulations.

.14 The auditor should obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of those laws and regulations generally recognized to have a direct effect on their determination.

Laws and Regulations Generally Recognized to Have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements

.15 Certain laws and regulations are well established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements. These laws and regulations generally are directly relevant to the determination of material amounts and disclosures in the financial statements and readily evident to the auditor. They could include those that relate to, for example,

- the form and content of financial statements (for example, statutorily-mandated requirements);
- industry-specific financial reporting issues;
- accounting for transactions under government contracts (for example, laws and regulations that may affect the amount of revenue to be accrued); or
- the accrual or recognition of expenses for income tax or pension costs.

.16 Some provisions in those laws and regulations may be directly relevant to specific assertions in the financial statements (for example, the completeness of income tax provisions), whereas others may be directly relevant to the financial statements as a whole. The auditor's responsibility regarding misstatements resulting from non-compliance with laws and regulations having a direct effect on the determination of material amounts and disclosures in the financial statements is the same as that for misstatements caused by fraud or error, as described in AU-C section 200.

.17 Non-compliance with other provisions of such laws and regulations, and the laws and regulations described in paragraph .06*b* of AU-C section 250, may result in fines, litigation, or other consequences for the entity, the costs of which may need to be provided for or disclosed in the financial statements but are not considered to have a direct effect on the financial statements.

.18 The auditor should perform the following audit procedures that may identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

a. Inquiring of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations

b. Inspecting correspondence, if any, with the relevant licensing or regulatory authorities

Procedures to Identify Instances of Non-compliance—Other Laws and Regulations

.19 Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity. Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations or call into question the entity's continuance as a going concern. For example, non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements).

.20 Many laws and regulations relating principally to the operating aspects of the entity do not directly affect the financial statements (their financial statement effect is indirect) and are not captured by the entity's information systems relevant to financial reporting. Their indirect effect may result from the need to disclose a contingent liability because of the allegation or determination of identified or suspected non-compliance. Those other laws or regulations may include those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, and price-fixing or other antitrust violations. An auditor may not have a sufficient basis for recognizing possible non-compliance with such laws and regulations.

.21 For the category referred to in paragraph .06*b* of AU-C section 250, the auditor's responsibility is limited to performing specified audit procedures that may identify non-compliance with those laws and regulations that may have a material effect on the financial statements. Even when those procedures are performed, the auditor may not become aware of the existence of non-compliance unless there is evidence of non-compliance in the records, documents, or other information normally inspected in an audit of financial statements.

.22 Because the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures required by paragraph .14 of AU-C section 250 are intended to bring to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

.23 In some cases, the amount of an entity's correspondence with licensing or regulatory authorities is voluminous. In exercising professional judgment in such circumstances, the auditor may consider the following in determining the extent of inspection that may identify instances of non-compliance:

- The nature of the entity
- The nature and type of correspondence

.24 During the audit, the auditor should remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

Non-compliance Brought to the Auditor's Attention by Other Audit Procedures

.25 Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include the following:

- Reading minutes
- Inquiring of the entity's management and in-house or external legal counsel concerning litigation, claims, and assessments
- Performing substantive tests of details of classes of transactions, account balances, or disclosures

.26 Because the effect of laws and regulations on financial statements can vary considerably, written representations, as required by AU-C section 580, provide necessary audit evidence about management's knowledge of identified or suspected non-compliance with laws and regulations, the effects of which may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the auditor.

.27 In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs .12–.15 of AU-C section 250 and the requirement in AU-C section 580 related to requesting written representations from management regarding the entity's compliance with laws and regulations.

Audit Procedures When Non-compliance Is Identified or Suspected

.28 If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor should obtain

a. an understanding of the nature of the act and the circumstances in which it has occurred and

b. further information to evaluate the possible effect on the financial statements.

Indications of Non-compliance With Laws and Regulations

.29 If the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organizations and government departments or payment of fines or penalties
- Payments for unspecified services or loans to consultants, related parties, employees, or government officials or government employees
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received
- Purchases made at prices significantly above or below market price
- Unusual payments in cash, purchases in the form of cashiers' checks payable to bearer, or transfers to numbered bank accounts
- Unusual transactions with companies registered in tax havens
- Payments for goods or services made other than to the country from which the goods or services originated
- Existence of an information system that fails, whether by design or accident, to provide an adequate audit trail or sufficient evidence
- Unauthorized transactions or improperly recorded transactions
- Adverse media comment
- Non-compliance with laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor
- Failure to file tax returns or pay government duties or similar fees that are common to the entity's industry or the nature of its business

Obtaining an Understanding of an Act of Identified or Suspected Non-compliance

.30 Procedures an auditor may perform to address the requirements of paragraph .17 of AU-C section 250 include the following:

- Examining supporting documents, such as invoices, cancelled checks, and agreements, and comparing with accounting records
- Confirming significant information concerning the matter with the other party to the transaction or intermediaries, such as banks or lawyers
- Determining whether the transaction has been properly authorized
- Considering whether other similar transactions or events may have occurred and applying procedures to identify them

Matters Relevant to the Auditor's Evaluation

.31 Matters relevant to the auditor's evaluation of the possible effect on the financial statements include the following:

- The quantitative effect of non-compliance. The potential financial consequences of non-compliance with laws and regulations on the financial statements may include the imposition of fines, penalties, or damages; the threat of expropriation of assets; enforced discontinuation of operations; and litigation.
- The qualitative materiality of the effect of non-compliance. For example, an illegal payment of an otherwise immaterial amount could be material if a reasonable possibility exists that it could lead to a material contingent liability or a material loss of revenue.
- Whether the potential financial consequences require accrual or disclosure under the applicable financial reporting framework. For example, if material revenue or earnings are derived from transactions involving non-compliance, or if non-compliance creates significant risks associated with material revenue or earnings, such as loss of a significant business relationship, that information may require disclosure. Loss contingencies resulting from non-compliance that may require disclosure may be evaluated in the same manner as other loss contingencies under the applicable financial reporting framework.
- Whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements or otherwise make the financial statements misleading.

Discussion With Those Charged With Governance or Legal Counsel

.32 If the auditor suspects non-compliance may exist, the auditor should discuss the matter with management (at a level above those involved with the suspected non-compliance, if possible) and, when appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's professional judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor should consider the need to obtain legal advice.

.33 The auditor may discuss the findings with those charged with governance, in which case they may be able to provide additional audit evidence. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the possibility of non-compliance with laws and regulations.

.34 If management or, as appropriate, those charged with governance do not provide sufficient information to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. The auditor may request management to arrange for such consultation with the entity's legal counsel. If it is not considered appropriate to consult with the entity's legal counsel or if the auditor is not satisfied with the legal counsel's opinion, the auditor may consider it appropriate to consult the auditor's own legal counsel about whether a violation of a law or regulation is involved; the possible legal consequences, including the possibility of fraud; and what further action, if any, the auditor may take.

Implications of Non-compliance on Other Aspects of the Audit

.35 If sufficient information about suspected non-compliance cannot be obtained, the auditor should evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

.36 The auditor should evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

.37 As required by paragraph .20 of AU-C section 250, the auditor evaluates the implications of non-compliance with regard to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of non-compliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

.38 The auditor may consider whether withdrawal from the engagement, when withdrawal is possible under applicable law or regulation, is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, even when the non-compliance is not material to the financial statements. Factors that may affect the auditor's decision may include the implications of the failure to take remedial action, which may affect the auditor's ability to rely on management representations, and the effects of continuing association with the entity. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. If withdrawal from the engagement is not possible under applicable law or regulation, the auditor may consider alternative actions, including describing the non-compliance in an other-matter(s) paragraph in the auditor's report.

Reporting Identified or Suspected Non-compliance

.39 Unless all of those charged with governance are involved in management of the entity and aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor should communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

.40 If, in the auditor's professional judgment, the non-compliance referred to in paragraph .21 of AU-C section 250 is believed to be intentional and material, the auditor should communicate the matter to those charged with governance as soon as practicable.

.41 If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor should communicate the matter to the next higher level of authority at the entity, if it exists. When no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure about the person to whom to report, the auditor should consider the need to obtain legal advice.

Reporting Non-compliance in the Auditor's Report on the Financial Statements

.42 If the auditor concludes that the non-compliance has a material effect on the financial statements, and it has not been adequately reflected in the financial statements, the auditor should, in accordance with AU-C section 705, express a qualified or adverse opinion on the financial statements.

.43 If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor should express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit, in accordance with AU-C section 705.

.44 If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor should evaluate the effect on the auditor's opinion, in accordance with AU-C section 705.

.45 If management or those charged with governance refuse to accept a modified opinion on the financial statements for the circumstances described in paragraphs .24–.25 of AU-C section 250, the auditor may withdraw from the engagement, when withdrawal is possible under applicable law or regulation, and indicate the reasons for withdrawal in writing to those charged with governance.

Reporting Non-compliance to Regulatory and Enforcement Authorities

.46 If the auditor has identified or suspects non-compliance with laws and regulations, the auditor should determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

.47 The auditor's professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside the entity. However, the auditor's legal responsibilities vary by jurisdiction, and in certain circumstances, the duty of confidentiality may be overridden by statute, the law, or courts of law. In the following circumstances, a duty to notify parties outside the entity may exist:

- In response to inquiries from an auditor to a predecessor auditor, in accordance with the requirements of AU-C section 210
- In response to a court order
- In compliance with requirements for the audits of entities that receive financial assistance from a government agency

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may consult with legal counsel before discussing non-compliance with parties outside the entity.

Documentation

.48 The auditor should include in the audit documentation a description of the identified or suspected non-compliance with laws and regulations and the results of discussion with management and, when applicable, those charged with governance and other parties inside or outside the entity.

.49 The auditor's documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example,

- copies of records or documents.
- minutes of discussions held with management, those charged with governance, or other parties inside or outside the entity.

[*The next page is 3331.*]

AAM Section 3155

Analytical Procedures

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 230, *Audit Documentation*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 500, *Audit Evidence*
- AU-C section 520, *Analytical Procedures*

.01 Analytical procedures are a natural extension of the auditor's understanding of the client's business and add to his or her understanding because the key factors that influence the client's business may be expected to affect the client's financial information. In the planning stage, the purpose of analytical procedures is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain audit evidence for specific account balances or classes of transactions. In accordance with paragraphs .A7–.A10 of AU-C section 315, analytical procedures should be performed as risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control. When performing audit procedures in response to assessed risks, the purpose of analytical procedures is to obtain evidence, sometimes in combination with other substantive procedures, to identify misstatements in account balances and, thus, to reduce the risk that misstatements will remain undetected. The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from substantive analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment about the expected effectiveness and efficiency of the available procedures. In the overall review stage, the objective of analytical procedures is to assist the auditor in forming an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity. In all cases, the effectiveness of analytical procedures lies in developing expectations that can reasonably be expected to identify unexpected relationships.

Analytical Procedures

.02 *Analytical procedures* are defined in paragraph .04 of AU-C section 520 as "evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount." The definition implies several key concepts:

- The "evaluations of financial information" suggests that analytical procedures will be used to understand or test financial statement relationships or balances.
- The "investigation ... of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount" implies an understanding of what can reasonably be expected and involves a comparison of the recorded book values with an auditor's expectations and an understanding of those differences.

- "Relationships among both financial and nonfinancial data" suggests that both types of data can be useful in understanding the relationships of the financial information and, therefore, in forming an expectation.

.03 A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. The reasons that make relationships plausible are an important consideration because data sometimes appears to be related when it is not, which may lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship may provide important evidence when appropriately scrutinized.

.04 Analytical procedures include the consideration of comparisons of the entity's financial information with, for example,

- comparable information for prior periods.
- anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable and gross margin percentages with industry averages or other entities of comparable size in the same industry.

.05 Analytical procedures also include consideration of relationships, for example,

- among elements of financial information, such as gross margin percentages, that would be expected to conform to a predictable pattern based on recent history of the entity and industry.
- between financial information and relevant nonfinancial information, such as payroll costs to number of employees.

.06 Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components, and individual elements of information.

.07 *Scanning* is a type of analytical procedure involving the auditor's exercise of professional judgment to review accounting data to identify significant or unusual items to test. This type of analytical procedure is described further in AU-C section 500.

.08 According to paragraph .06 of AU-C section 315, risk assessment procedures should include analytical procedures. Section 3120, "Obtaining an Understanding of the Entity and Its Environment," of this manual discusses the requirements and guidance included in AU-C section 315, including the use of analytical procedures when performing risk assessment procedures.

.09 AU-C section 330 establishes requirements and provides guidance on the use of analytical procedures as substantive procedures.

Auditor Requirements

Substantive Analytical Procedures

.10 When designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with AU-C section 330, the auditor should *a.* determine the suitability of particular substantive analytical procedures for given assertions, taking into account the assessed risks of material misstatement and tests of details, if any, for these assertions;

b. evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation;

c. develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

d. determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph .07 of AU-C section 520 and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations.

.11 The auditor's substantive procedures to address the assessed risk of material misstatement for relevant assertions may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's professional judgment about the expected effectiveness and efficiency of the available audit procedures to reduce the assessed risk of material misstatement to an acceptably low level.

.12 The expected effectiveness and efficiency of a substantive analytical procedure in addressing risks of material misstatement depends on, among other things, (*a*) the nature of the assertion, (*b*) the plausibility and predictability of the relationship, (*c*) the availability and reliability of the data used to develop the expectation, and (*d*) the precision of the expectation.

.13 The auditor may inquire of management about the availability and reliability of information needed to apply substantive analytical procedures and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided that the auditor is satisfied that such data is properly prepared.

Suitability of Particular Substantive Analytical Procedures for Given Assertions

.14 When more persuasive audit evidence is desired from substantive analytical procedures, more predictable relationships are necessary to develop the expectation. Relationships in a stable environment are usually more predictable than relationships in a dynamic or unstable environment. Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts because income statement accounts represent transactions over a period of time, whereas balance sheet accounts represent amounts as of a point in time. Relationships involving transactions subject to management discretion may be less predictable. For example, management may elect to incur maintenance expense rather than replace plant and equipment, or they may delay advertising expenditures.

.15 Substantive analytical procedures are generally more effective for large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. Particular conditions that can cause variations in these relationships include, for example, specific unusual transactions or events, accounting changes, business changes, random fluctuations, or misstatements. The suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

.16 In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, when an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

.17 Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments, and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided that the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence but may provide useful corroboration if used in combination with other audit procedures.

.18 The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over payroll processing are deficient, the auditor may need to perform more extensive tests of details for assertions related to compensation.

.19 Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts, in addition to performing tests of details on subsequent cash receipts, to determine the collectability of the receivables.

The Reliability of the Data

.20 The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- *a.* The source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity.
- *b.* The comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products.
- *c.* The nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved.
- *d.* Controls over the preparation of the information that are designed to ensure its completeness, accuracy, and validity. For example, controls over the preparation, review, and maintenance of budgets.

.21 Data may be readily available to develop expectations for some assertions. For example, the auditor may consider whether financial information, such as budgets or forecasts, and nonfinancial information, such as the number of units produced or sold, is available to design substantive analytical procedures.

.22 The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor may have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over nonfinancial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. AU-C section 330 addresses determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

.23 The matters discussed in paragraph .A17*a–d* of AU-C section 520 are relevant irrespective of whether the auditor performs substantive analytical procedures on the entity's period-end financial statements or at an interim date and plans to perform substantive analytical procedures for the remaining period. AU-C section 330 addresses performing substantive procedures at an interim date.

Evaluation of Whether the Expectation Is Sufficiently Precise

.24 In evaluating whether the expectation is sufficiently precise when performing a substantive analytical procedure, it is appropriate for the auditor to take into account whether substantive analytical procedures are the only substantive procedures planned to address a particular risk of misstatement at the relevant assertion level or whether the risk will be addressed through a combination of substantive analytical procedures and tests of details. A less precise expectation may be appropriate when evidence obtained from performing the substantive analytical procedure will be combined with audit evidence from performing tests of details. A more precise expectation, however, is necessary when the substantive analytical procedure is the only procedure planned to address a particular risk of misstatement for a relevant assertion.

.25 As expectations become more precise, the range of expected differences becomes narrower, and accordingly, the likelihood increases that significant differences from the expectations are due to misstatements. Matters relevant to the auditor's evaluation of whether the expectation can be developed with sufficient precision to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include the following:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity than when applied to the financial statements of the entity as a whole.

.26 When expectations are developed at a more detailed level, it is more likely that the analytical procedure will more effectively address the assessed risk of misstatement to which it is directed. Monthly amounts may be more effective than annual amounts, and comparisons by location or line of business usually are more effective than company-wide comparisons. The appropriate level of detail may be influenced by the nature of the entity, its size, and its complexity. The risk that material misstatements may be obscured by offsetting factors increases as an entity's operations become more complex and diversified. Disaggregation of the information helps reduce this risk.

Amount of Acceptable Difference of Recorded Amounts From Expected Values

.27 The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality and the desired level of assurance, while taking into account the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. AU-C section 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without further investigation decreases in order to achieve the desired level of persuasive evidence.

Analytical Procedures That Assist When Forming an Overall Conclusion

.28 The auditor should design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity.

.29 A wide variety of analytical procedures may be used when forming an overall conclusion. These procedures may include reading the financial statements and considering (*a*) the adequacy of the evidence gathered in response to unusual or unexpected balances identified during the course of the audit and (*b*) unusual or unexpected balances or relationships that were not previously identified. Results of these analytical procedures may indicate that additional evidence is needed.

.30 The results of analytical procedures designed and performed in accordance with paragraph .06 may identify a previously unrecognized risk of material misstatement. In such circumstances, AU-C section 315 requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.

.31 The analytical procedures performed in accordance with paragraph .06 of AU-C section 520 may be similar to those that would be used as risk assessment procedures.

Investigating Results of Analytical Procedures

.32 If analytical procedures performed in accordance with this section identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor should investigate such differences by

a. inquiring of management and obtaining appropriate audit evidence relevant to management's responses and

b. performing other audit procedures as necessary in the circumstances.

.33 Audit evidence relevant to management's responses may be obtained by evaluating those responses, taking into account the auditor's understanding of the entity and its environment and other audit evidence obtained during the course of the audit.

.34 The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Audit Documentation

.35 When substantive analytical procedures have been performed, the auditor should include in the audit documentation the following:

a. The expectation referred to in paragraph .05*c* of AU-C section 520 and the factors considered in its development when that expectation or those factors are not otherwise readily determinable from the audit documentation

b. Results of the comparison referred to in paragraph .05*d* of AU-C section 520 of the recorded amounts, or ratios developed from recorded amounts, with the expectations

c. Any additional auditing procedures performed in accordance with paragraph .07 of AU-C section 520 relating to the investigation of fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount and the results of such additional procedures

.36 AU-C section 230 addresses the auditor's responsibilities for preparing audit documentation and applies to substantive analytical procedures and analytical procedures performed near the end of the audit. Although paragraph .08 of AU-C section 520 addresses specific requirements that apply to substantive analytical procedures, it is not intended to provide a complete list of items that are required to be documented by AU-C section 230.

Analytical Procedures Performed as Risk Assessment Procedures

.37 Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and nonfinancial information (for example, the relationship between sales and square footage of selling space or volume of goods sold).

.38 Analytical procedures may enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior audit and also may help to identify the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

.39 However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

.40 *Considerations specific to smaller, less complex entities*. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

Audit Guide *Analytical Procedures*

.41 For additional guidance, practitioners may refer to the AICPA Audit Guide *Analytical Procedures*. The guide provides practical guidance for auditors on the effective use of analytical procedures. Specifically, the guide includes a discussion of AU-C section 520; concepts and definitions; a series of questions and answers, grouped in the following five categories: precision of the expectation, relationship of analytical procedures to the audit risk model, evaluation and investigation, purpose of analytical procedures, and fraud; and a case study illustrating the four types of expectation methods discussed in chapter 1, "The Use of Analytical Procedures," of the guide: trend analysis, ratio analysis, reasonableness testing, and regression analysis.

.42 The AICPA Audit Guide *Analytical Procedures* also includes illustrations that demonstrate the importance of forming expectations and considering the precision of the expectation, two of the most misunderstood concepts from AU-C section 520. However, the guide focuses principally on how the concepts are applied to substantive testing because in designing substantive analytical procedures, a specified level of assurance is ordinarily desired. The guide is available at www.cpa2biz.com (enter product code no. AAGANP12P) or by calling the AICPA order department at 888.777.7077.

[*The next page is 3361.*]

AAM Section 3160

Audit Budget Samples

.01 Audit Time Budget—Sample A

Client: __________

Audit date: __________

Prepared by: __________

Preliminary work:	Approved:
Start:	Supervisor:
End:	Date:

Final work:	Approved:
Start:	Partner:
End:	Date:

	Budget (in hours)	
	May to Nov.	Dec. to April
Cash		
Receivables:		
Confirmation of balances		
Review ledgers, etc.		
Inventories:		
Observation of physical counts		
Price tests, etc.		
Securities and investments		
Property, plant, and equipment		
Accumulated depreciation and amortization		
Other assets		
Notes and accounts payable		
Tax accruals		
Other liabilities		
Capital stock		
Retained earnings		
Other equity accounts		
Income accounts		
Costs and expense accounts		
Current provision for taxes		
Other income and expense accounts		

(continued)

Minutes, agreements, etc.		
Conferences with client		
General supervision and planning		
Review computers programs and auditability		
Review of internal control		
Review and update permanent files		
Travel		
Report and statement review		
Other matters (describe)		
Total budgeted hours		
(*Excludes tax and report departments' time*)		

.02 Audit Time Budget—Sample B

Client:

Audit date:

	General														Cash		
	Audit program	Prior period reports, working papers, etc.	Trial balance and adjusting entries	Permanent file	Financial statement comparison	Transaction since balance sheet date	Preparation of reports	Internal control questionnaire and mgmt. letter	Time summary	Supervision	Correspondence and conferences	Review in-house computer programs	Audit of/with computer	General ledger and journal entries	In banks and on hand	Receipts and disbursements	Notes/accts. rec. and allowance for losses
Budget																	
Partner or lead																	
Supervisor or manager																	
Senior or in-charge																	
Audit staff or assistant																	
Total																	
Actual																	
Partner or lead																	
Supervisor or manager																	
Senior or in-charge																	
Audit staff or assistant																	
Total																	
Variance—over/(under)																	

(continued)

Client:																						
Audit date:																						
	Inventories																			**Other (*describe*)**		
	Observations	Comparison of quantities	Valuation	Clerical accuracy and analytical review	Prepaid expenses	Other current assets	Fixed assets and depreciation	Investments	Other assets	Notes payable and longterm debt	Accounts payable	Other current liabilities	Other long-term liabilities and deferred income	Stockholders' equity	Contingent liabilities	Sales and revenue	Payroll	Other expense and income tests and analysis	Preparation of tax returns			
Budget																						
Partner or lead																						
Supervisor or manager																						
Senior or in-charge																						
Audit staff or assistant																						
Total																						
Actual																						
Partner or lead																						
Supervisor or manager																						
Senior or in-charge																						
Audit staff or assistant																						
Total																						
Variance—over/(under)																						

.03 Weekly Progress Report

Client: ______________________

Date: ______________________

In-charge auditor: ______________________

Supervisor: ______________________

	Original hours estimate	Hours used to date	Unused hours	Est. hours to complete	Variance—(over)/ under
In-charge auditor					
Assistants (list):					
Total assistants					
Grand total					

.04 Audit Status Analysis

Client: ____________________

Audit Date: ____________________

	Budgeted Hours	Partner or Lead	Manager or Supervisor	Senior or In-Charge	Audit Staff or Assistant	Total Hours Incurred	Variance—Over/ (Under)	Explanation for Variances
Administration								
Client conferences								
Planning and scheduling								
Staff supervision								
Accounting systems review								
Internal control								
General ledger								
Cash								
Sales								
Voucher register								
Payroll								
Journal entries								
Confirmations								
Permanent file								
Client advisory comments								
Report preparation								
Financial statements								
Footnotes								
Tax return preparation								
Review								
Initial review								
Overall review								

Client: ____________________

Audit Date: ____________________

	Budgeted Hours	Partner or Lead	Manager or Supervisor	Senior or In-Charge	Audit Staff or Assistant	Total Hours Incurred	Variance—Over/ (Under)	Explanation for Variances
Detailed review								
Tax accrual review								
Year end verification								
Trial balance								
Assets:								
Cash								
Notes receivable								
Accounts receivable								
Inventories								
Prepaid expenses								
Intercompany accounts								
Securities and investments								
Fixed assets								
Other assets								
Liabilities:								
Notes payable								
Accounts payable								
Tax grouping and accrual								
Accrued liabilities								
Deferred credits								
Contingencies and commitments								

(continued)

Client: ____________

Audit Date: ____________

	Budgeted Hours	Partner or Lead	Manager or Supervisor	Senior or In-Charge	Audit Staff or Assistant	Total Hours Incurred	Variance—Over/(Under)	Explanation for Variances
Equity								
Revenues								
Expenses								
Other (*describe*):								
Total								

[*The next page is 3401.*]

AAM Section 3165

Sample Engagement Letters

This section contains the following reference from AICPA *Professional Standards*:

AU-C Section:

- AU-C section 210, *Terms of Engagement*

.01 The following is an illustrative example of an engagement letter; it may not include all representations necessary for a particular engagement. It may be used as a starting point in the design of specific letters and then tailored to satisfy the terms of a particular engagement. This illustrative engagement letter is intended to be used in connection with engagements of nonpublic entities and is not intended to be used in connection with audits of public entities that are required to be audited under standards set by the PCAOB. The auditor may seek legal advice about whether a proposed letter is suitable. AU-C section 210 establishes standards and provides guidance regarding the auditor's responsibility to agree upon the terms of the audit engagement with management and, when appropriate, those charged with governance. AU-C section 210 is discussed further in section 3105, "Planning the Engagement," of this manual.

Additional Resources for Practitioners

The AICPA offers an online tool, *The Engagement Letter: Best Practices and Examples*, to provide practitioners with additional illustrative engagement letters. This tool provides guidance on developing engagement letters in accordance with applicable AICPA professional standards, and subscribers to this tool can download the sample engagement letters for easy mark up and customization. The tool is available at www.cpa2biz.com (enter product code no. APAEGLO) or by calling the AICPA at 888.777.7077.

.02 Audit Engagement Leading to Opinion

LACKO, LYNCH, BROWN & COMPANY Certified Public Accountants

To the appropriate representative of those charged with governance of ABC Company, Inc. (the Company)[1]

[*The objective and scope of the audit*]

You[2] have requested that we audit the financial statements of ABC Company, Inc., which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stock-holders' equity, and cash flows for the year then ended, and the related notes to the financial statements. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

[*The responsibilities of the auditor*]

We will conduct our audit in accordance with auditing standards generally accepted in the United States of America (GAAS). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing

[1] The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons. Paragraph .A20 of AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), provides guidance regarding agreeing upon the terms of the audit engagement.

[2] Throughout this letter, references to *you*, *we*, *us*, *management*, *those charged with governance*, and *auditor* would be used or amended as appropriate in the circumstances.

procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk that some material misstatements may not be detected exists, even though the audit is properly planned and performed in accordance with GAAS.

In making our risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies or material weaknesses in internal control relevant to the audit of the financial statements that we have identified during the audit.

[*The responsibilities of management and identification of the applicable financial reporting framework*]

Our audit will be conducted on the basis that [*management and, when appropriate, those charged with governance*][3] acknowledge and understand that they have responsibility

a. for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America;

b. for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

c. to provide us with

  i. access to all information of which [management] is aware that is relevant to the preparation and fair presentation of the financial statements such as records, documentation, and other matters;

  ii. additional information that we may request from [management] for the purpose of the audit; and

  iii. unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from [*management and, when appropriate, those charged with governance*], written confirmation concerning representations made to us in connection with the audit.

[*Other engagement matters and limitations*]

As part of our engagement for the year ending December 31, 20X1, we will review the federal and state income tax returns for ABC Company, Inc. Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Professional standards require us to be independent with respect to the Company in the performance of our services. Any discussions that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual's base compensation at the Company, [xx] days from the first day of employment.

[*Audit administration, fees, and other*]

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain

[3] Use terminology as appropriate in the circumstances.

committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.[4]

GAAS require that we communicate certain additional matters related to the conduct of our audit to those charged with governance. Such matters include (1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an overview of the planned scope and timing of the audit; (3) significant findings from the audit, including, among others: (*a*) the initial selection of and changes in significant accounting policies and their application; (*b*) the process used by management in formulating particularly sensitive accounting estimates and the basis for our conclusions regarding the reasonableness of those estimates; (*c*) significant difficulties that we encountered in dealing with management related to the performance of the audit; (*d*) audit adjustments that could, in our judgment, either individually or in the aggregate, have a significant effect on your financial reporting process and uncorrected misstatements of the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (*e*) any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or our report; (*f*) management representations; (*g*) our views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters; (*h*) major issues that were discussed with management in connection with the retention of our services, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, and if applicable, events or conditions indicating there could be a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time; and (4) other matters as considered necessary or required to be communicated under professional standards.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

Our fees will be billed as work progresses and are based on the amount of time required plus out of pocket costs and administrative expenses. Invoices are payable upon presentation. Our initial fee estimate assumes we will receive the aforementioned assistance from your personnel and unexpected circumstances will not be encountered. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees, which we estimate to range from $XX,XXX to $XX,XXX. Additional expenses are expected to be $X,XXX.

The audit documentation for this engagement is the property of Lacko, Lynch, Brown & Company and constitutes confidential information. However, we may be requested to make certain audit documentation available to ______________________ [*name of regulator*] pursuant to authority given to it by law or regulation. If requested, access to such audit documentation will be provided under the supervision of Lacko, Lynch, Brown & Company personnel. Furthermore, upon request, we may provide photocopies of selected audit documentation to ______________________________ [*name of regulator*]. The ____________________ [*name of*

[4] Ethics Ruling No. 112, "Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services," under Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, ET sec. 191 par. .224–.225), requires that clients be informed if the firm will outsource professional services to third party service providers. If an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.

regulator] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.

[*Reporting*]

We will issue a written report upon completion of our audit of ABC Company, Inc.'s financial statements. Our report will be addressed to the board of directors of ABC Company, Inc. We cannot provide assurance that an unmodified opinion will be expressed. Circumstances may arise in which it is necessary for us to modify our opinion, add an emphasis-of-matter or other-matter paragraph(s), or withdraw from the engagement.

We also will issue a written report on [*Insert appropriate reference to other auditor's reports expected to be issued*.] upon completion of our audit.

We appreciate the opportunity to serve you. If you have any questions, please contact us. Please sign and return the attached copy of this letter to indicate your acknowledgment of, and agreement with, the arrangements for our audit of the financial statements, including our respective responsibilities.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

____

[*Engagement Partner's Signature*]

Accepted and agreed to:

____

[*Sign*]

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[*Name and Title*]

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[*Date*]

[*The next page is 4001.*]

AAM Section 4000
Internal Control

The material included in these sections on internal control is presented for illustrative purposes only. The comments and illustrations are neither all inclusive nor are they prescribed minimums. They are intended as conveniences for users of this manual who may want assistance when developing materials to meet their individual needs.

This manual is a nonauthoritative kit of practice aids and, accordingly, these sections on internal control do not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

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AAM Section 4100

Introduction

This section contains the following reference from AICPA *Professional Standards*:

AU-C Section:

- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

Note: In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued the 2013 *Internal Control–Integrated Framework* (the framework). The framework was originally published in 1992 to provide guidance for designing, implementing and conducting internal control and assessing its effectiveness. COSO has updated the framework to reflect changes in the business environment, particularly in the areas of technology, global activities, and outsourced service providers. The changes to the framework are intended to provide better guidance to management and the board of directors in fulfilling their internal control responsibilities, while still meeting the entity's operations and financial performance goals, as well as compliance with laws and regulations. In addition to addressing the known changes that have occurred over the past two decades, the updated framework helps entities address future changes including economic and competitive environments, organization leadership, business priorities, and evolving business models. Many of the updates to the framework have significant implications for small businesses.

COSO is encouraging users to transition their applications and related documentation to the updated framework as soon as is feasible under their particular circumstances. The original framework will be available during the transition period extending to December 15, 2014, after which time COSO will consider it as superseded by the 2013 framework.

The following section has been updated for the 2013 framework. To assist users in the transition, the AICPA has released a new publication, *Internal Control for Today's Smart Business*, which is available through the AICPA Store at www.cpa2biz.com.

Readers are also encouraged to consult the full text of the framework.

.01 *Internal control* is broadly defined by COSO as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

.02 COSO acknowledges that the previous definition reflects certain fundamental concepts that follow:

A process. Internal control is a process. It is not one event or circumstance but a series of ongoing tasks and activities.

People. Internal control is effected by people. It is not accomplished by policy manuals and forms but by the people of an organization and the actions that they take. People need to know their responsibilities and limits of authority.

Reasonable assurance. Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's objectives.

Achievement of objectives. Internal control is geared to the achievement of entity objectives. The definitions of these objectives provide auditors with a useful framework for understanding and analyzing internal control.

Adaptable to the entity structure. Internal control should be flexible in its application. This pertains to how it's applied to the entity as a whole, or for a particular subsidiary, division, operating unit, or business process.

.03 As discussed in section 3125, "Obtaining an Understanding of Internal Control," AU-C section 315 requires the auditor to obtain an understanding of internal control relevant to the audit and provides guidance to help the auditor obtain an understanding of internal control.

.04 An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures.

.05 The internal control framework developed by COSO breaks internal control into five components as identified and discussed in section 4200, "Internal Control Framework." The division of internal control into the five components provides a useful framework for auditors when obtaining an understanding of internal control relevant to the audit.

.06 Section 4200 provides more detail on the COSO internal control framework described in AU-C section 315 and controls relevant to the audit. Refer to section 5100, "Audit Evidence and Designing Further Audit Procedures," for guidance pertaining to the design of further audit procedures (tests of controls or substantive procedures, or both) and section 5200, "Performing Tests of Controls," for specific guidance on the performance of tests of controls.

[*The next page is 4201.*]

AAM Section 4200

Internal Control Framework

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 260, *The Auditor's Communication With Those Charged With Governance*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*
- AU-C section 610A, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*
- AU-C section 935, *Compliance Audits*

Note: In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued the 2013 *Internal Control–Integrated Framework* (the framework). The framework was originally published in 1992 to provide guidance for designing, implementing and conducting internal control and assessing its effectiveness. COSO has updated the framework to reflect changes in the business environment, particularly in the areas of technology, global activities, and outsourced service providers. The changes to the framework are intended to provide better guidance to management and the board of directors in fulfilling their internal control responsibilities, while still meeting the entity's operations and financial performance goals, as well as compliance with laws and regulations. In addition to addressing the known changes that have occurred over the past two decades, the updated framework helps entities address future changes including economic and competitive environments, organization leadership, business priorities, and evolving business models. Many of the updates to the framework have significant implications for small businesses.

COSO is encouraging users to transition their applications and related documentation to the updated framework as soon as is feasible under their particular circumstances. The original framework will be available during the transition period extending to December 15, 2014, after which time COSO will consider it as superseded by the 2013 framework.

The following section has been updated for the 2013 framework. To assist users in the transition, the AICPA has released a new publication, *Internal Control for Today's Smart Business*, which is available through the AICPA Store at www.cpa2biz.com.

Readers are also encouraged to consult the full text of the framework.

General Nature and Characteristics of Internal Control

Internal Control Framework

.01 Internal control is designed, implemented, and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern the following:

Financial reporting. These objectives pertain to the preparation of reports for use by organizations and stakeholders. Reporting objectives may relate to internal and external financial and nonfinancial reporting and may encompass reliability, timeliness, transparency, or other terms as set forth by regulators, standard setters, or the entity's policies.

Operations. These objectives relate to the achievement of an entity's basic mission and vision, including improving operational and financial performance goals, and safeguarding assets against loss.

Compliance. These objectives pertain to adherence to laws and regulations to which the entity is subject.

The way in which internal control is designed, implemented, and maintained varies with an entity's size and complexity.

> ***Practical example:*** *The bank reconciliation performed by the Jones Grocery controller is an example of a control that relates primarily to the* ***financial reporting*** *objective. Jones also has an inventory tracking and management system that allows each store manager to track inventory levels and order new items before they stock-out. This control activity is part of the* ***operations*** *objective. Each store also has a small deli that prepares sandwiches and hot entrees. These food preparation activities must comply with state health laws and regulations, and Jones has policies in place to help ensure that those laws and regulations are met. Those policies are directed at the entity's* ***compliance*** *objective.*

.02 The COSO framework sets forth the five following integrated internal control components:

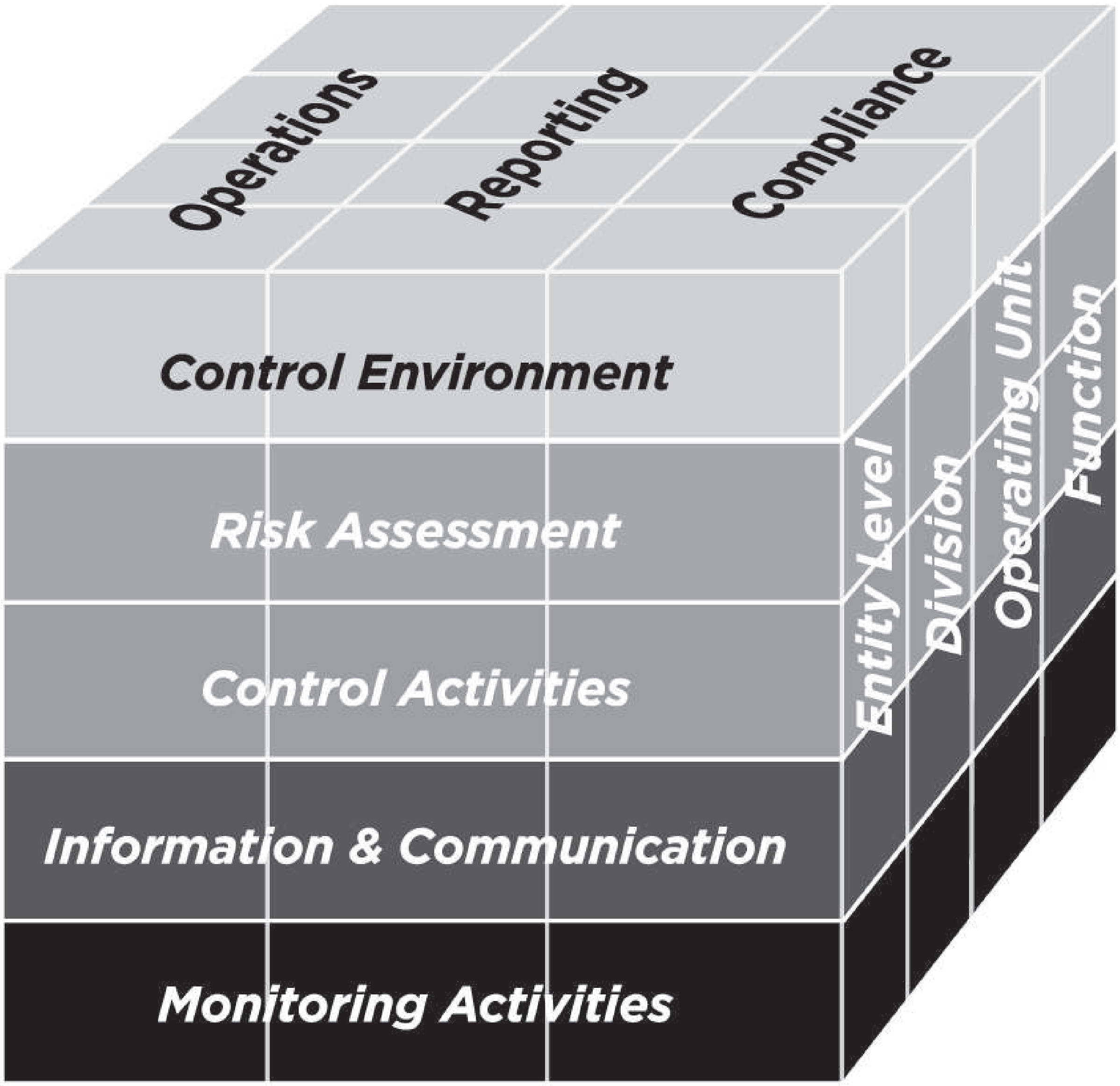
- **Control environment.** The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organization. The control environment comprises the integrity and ethical values of the organization; the parameters enabling the board of directors to carry out its governance oversight responsibilities; the organizational structure and assignment of authority and responsibility; the process for attracting, developing, and retaining competent individuals; and the rigor around performance measures, incentives, and rewards to drive accountability for performance. The resulting control environment has a pervasive impact on the overall system of internal control.
- **Risk assessment.** Every entity faces a variety of risks from external and internal sources. Risk is defined as the possibility that an event will occur and adversely affect the achievement of objectives. Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Risks to the achievement of these objectives from across the entity are considered relative to established risk tolerances. Thus, risk assessment forms the basis for determining how risks will be managed. A precondition to risk assessment is the establishment of objectives, linked at different levels of the entity. Management specifies objectives within categories relating to operations, reporting, and compliance with sufficient clarity to be able to identify and analyze risks to those objectives. Management also considers the suitability of the objectives for the entity. Risk assessment also requires management to consider the impact of possible changes in the external environment and within its own business model that may render internal control ineffective.
- **Information and communication systems.** Information is necessary for the entity to carry out internal control responsibilities to support the achievement of its objectives. Management obtains or generates and uses relevant and quality information from both internal and external sources to support the functioning of other components of internal control. Communication is the continual, iterative process of providing, sharing, and obtaining necessary information. Internal communication is the means by which information is disseminated throughout the organization, flowing up, down, and across the entity. It enables personnel to receive a clear message from senior management that control responsibilities must be taken seriously. External communication is twofold: it enables inbound communication of relevant external information, and it provides information to external parties in response to requirements and expectations.
- **Control activities.** Control activities are the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity, at various stages within business

processes, and over the technology environment. They may be preventive or detective in nature and may encompass a range of manual and automated activities such as authorizations and approvals, verifications, reconciliations, and business performance reviews. Segregation of duties is typically built into the selection and development of control activities. Where segregation of duties is not practical, management selects and develops alternative control activities.

- **Monitoring.** Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control, including controls to effect the principles within each component, is present and functioning. Ongoing evaluations, built into business processes at different levels of the entity, provide timely information. Separate evaluations, conducted periodically, will vary in scope and frequency depending on assessment of risks, effectiveness of ongoing evaluations, and other management considerations. Findings are evaluated against criteria established by regulators, recognized standard-setting bodies or management and the board of directors, and deficiencies are communicated to management and the board of directors as appropriate.

Essential to the understanding of how these concepts work together is the direct relationship between objectives, components, and the entity's structure. The relationship is often depicted in the form of a cube (see the following diagram) with the following characteristics:

- *Objectives.* The three objectives are represented by the X axis.
- *Components.* The five components are represented by the Y axis.
- *Structure.* The entity's structure, which includes the divisions, subsidiaries, operating units, and functions or business processes (that is, sales, purchasing, operations, payroll, and accounting) are represented by the Z axis.



As shown in the preceding diagram, these components are relevant to an entire entity as well as its internal departments or other subsets of the entity (including outsourced service providers). Each component cuts across and applies to all three categories of objectives (for example, operations objectives relate to the efficiency and effectiveness of operations, not specific operating units or functions such as sales, marketing, purchasing, or human resources). The framework provides principles representing the fundamental concepts associated with the components. The components of internal control are suitable for all entities. The principles are presumed to be implemented for all entities unless the entity determines that a specific principle is not relevant.

.03 *Considerations specific to smaller, less complex entities*. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives. For example, smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures or detailed written policies. For some entities, in particular very small entities, the owner-manager (the proprietor of an entity who is involved in running the entity on a day-to-day basis) may perform functions that in a larger entity would be regarded as belonging to several of the components of internal control. Therefore, the components of internal control may not be clearly distinguished within smaller entities, but their underlying purposes are equally valid.

Practical example: *Suppose you are the auditor of Jones Grocery. As on all audits, you should obtain an understanding of internal control sufficient to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. To achieve this, you organize your inquiries and other procedures to understand each of the five components of internal control that relate to the financial reporting objectives. As a result of performing your procedures, you discover the client's bank reconciliation procedures. Should a bank reconciliation be considered a "control procedure"? What about the fact that someone follows up and investigates old or unusual reconciling items? Is that considered a "monitoring" activity?*

These questions are rhetorical because the issue of how to classify a particular control is irrelevant for your purposes. As an auditor, your primary consideration is to understand how the bank reconciliations, whether individually or in combination with other controls, affect financial statement assertions relating to cash.

Limitations of Internal Control

.04 Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These limitations are supported by two concepts: (1) internal control operates at different levels for different objectives and (2) no system of internal control will always perform as it is designed. These limitations include the realities that human judgment in decision making can be faulty and that breakdowns in internal control can occur because of human error. For example, an error in the design of, or in the change to, a control may exist. Equally, the operation of a control may not be effective, such as when information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action. Internal controls can also be subject to failure due to external events beyond the entity's control.

.05 Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into undisclosed agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

.06 Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement and the nature and extent of the risks it chooses to assume.

.07 *Considerations specific to smaller, less complex entities*. Smaller entities often have fewer employees, which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

.08 The division of internal control into the five components, for purposes of generally accepted auditing standards, provides a useful framework for auditors when considering how different aspects of an entity's internal control may affect the audit. However, the division does not necessarily reflect how an entity designs, implements, and maintains internal control or how it may classify any particular component. This section provides additional discussion of internal control, including the five components of internal control.

.09 An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

Controls Relevant to the Audit

.10 A direct relationship exists between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives and, therefore, controls relate to financial reporting, operations, and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment. Although internal control applies to the entire entity or any of its operating units or business functions, an understanding of internal control relating to each of the entity's operating units and business functions may not be necessary to the performance of the audit.

.11 Factors relevant to the auditor's professional judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality
- The significance of the related risk
- The size of the entity
- The nature of the entity's business, including its organization and ownership characteristics
- The diversity and complexity of the entity's operations
- Applicable legal and regulatory requirements
- The circumstances and the applicable component of internal control
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations
- Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements

.12 Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further audit procedures.

.13 Controls relating to operations and compliance objectives also may be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures. For example, controls pertaining to nonfinancial data that the auditor may use in analytical procedures, such as production statistics, or controls pertaining to detecting non-compliance with laws and regulations that may have a direct effect on the determination of material amounts and disclosures in the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit. An auditor may consider controls relevant to compliance objectives when performing an audit in accordance with AU-C section 935.

.14 Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

.15 Ordinarily, relevant controls for an audit relate to the financial reporting objective. Controls relating to operations and compliance objectives that are not relevant to an effective audit need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. However, as stated in paragraph .30 of AU-C section 315, if the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks.

Practical example: *As previously discussed, the Jones family owns and operates several neighborhood grocery stores in Anytown. The bank reconciliation performed by the Jones Grocery controller is an example of a control that relates primarily to the* financial reporting *objective. Jones also has an inventory tracking and management system that allows each store manager to track inventory levels and order new items before they run out of stock. This control activity is part of the* operations *objective. Each store has a small deli that prepares sandwiches and some hot foods. These food preparation activities must comply with state health laws and regulations, and Jones has policies in place to help ensure that those laws and regulations are met. Those policies are directed at the* compliance *objective of the entity.*

The controls having to do with the ordering of inventory or compliance with state health laws and regulations are important to Jones Grocery but ordinarily will not relate to the audit of the company's financial statements. The auditor of Jones Grocery may wish to inquire and document these controls for client service or other purposes, but because these controls are not relevant to the audit, he or she is not required to do so.

.16 However, if controls relating to operations and compliance objectives pertain to data the auditor evaluates or uses in applying auditing procedures, then they may be relevant to the audit.

.17 For example, the financial reporting system may produce a sales report by inventory stock number for each sales region. If the auditor decided to use information from this report when auditing the proper valuation of inventory, he or she may consider obtaining an understanding of the following:

- Which transactions or classes of transactions are included in the report
- How significant accounting information about those transactions are entered into and flow through the financial reporting system
- The files that are processed
- The nature of processing involved in producing the report

.18 Controls designed to prevent or detect misappropriations of assets may include controls relating to financial reporting and operations objectives. For example, use of a lockbox system for collecting cash or access controls, such as passwords that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. An auditor's responsibility to understand internal control is generally limited to those controls relevant to the reliability of financial reporting.

Effect of IT on Internal Control

.19 An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives and its operating units or business functions. For example, an entity may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, an entity may have complex, highly integrated systems that share data and that are used to support all aspects of the entity's financial reporting, operations, and compliance objectives.

.20 The following use of manual or automated elements in internal control also affects the manner in which transactions are initiated, authorized, recorded, processed, and reported:

- Controls in a manual system may include such procedures as approvals and reviews of transactions and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, authorize, record, process, and report transactions, in which case records in electronic format replace paper documents.

- Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT or may use information produced by IT. They also may be limited to monitoring the effective functioning of IT and automated controls and to handling exceptions. When IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

.21 Generally, IT benefits an entity's internal control by enabling an entity to

- consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- enhance the timeliness, availability, and accuracy of information;
- facilitate the additional analysis of information;
- enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- reduce the risk that controls will be circumvented; and
- enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

.22 IT also poses specific risks to an entity's internal control, including, for example

- reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions. Particular risks may arise when multiple users access a common database.
- the possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation of duties.
- unauthorized changes to data in master files.
- unauthorized changes to systems or programs.
- failure to make necessary changes to systems or programs.
- inappropriate manual intervention.
- potential loss of data or inability to access data as required.

.23 Manual elements in internal control may be more suitable when judgment and discretion are required, such as for the following circumstances:

- Large, unusual, or nonrecurring transactions
- Circumstances where misstatements are difficult to define, anticipate, or predict
- Changing circumstances that require a control response outside the scope of an existing automated control
- Monitoring the effectiveness of automated controls

.24 Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden, and they are also more prone to simple errors and mistakes.

Consistency of application of a manual control element cannot, therefore, be assumed. Manual control elements may be less suitable for the following circumstances:

- High volume or recurring transactions, or in situations in which errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated
- Control activities in which the specific ways to perform the control can be adequately designed and automated

.25 The extent and nature of these risks to internal control vary depending on the nature and characteristics of the entity's information system. For example, multiple users, either external or internal, may access a common database of information that affects financial reporting. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data. When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This could result in unauthorized transactions or changes to programs or data that affect the financial statements. Therefore, the nature and characteristics of an entity's use of IT in its information system affect the entity's internal control.

.26 The purpose of this section is to provide guidance on each of the five components that comprise the internal control framework. This guidance may help the auditor when performing procedures to obtain an understanding of internal control. Section 3125, "Obtaining an Understanding of Internal Control," provides additional discussion on the requirements for the auditor to obtain an understanding of internal control.

Focus on the Small Business Entity

.27 This section emphasizes the audit of a small business entity. Small business entities are typically characterized by

- a single owner or a small group of owners who manage the business on a day to day basis;
- a small number of employees involved in the accounting function;
- no outside board of directors or internal audit function; and
- the use of off-the-shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

.28 This section also provides discussion of guidance applicable to audits of medium to large businesses.

Internal Control Components

Understanding the Control Environment

.29 The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation upon which all other components of internal control are based, providing discipline and structure. The control environment extends beyond the idea of culture and comprises the following:

- The organization's integrity and ethical values
- The board of directors' oversight responsibilities
- The assignment of authority and responsibility
- The process for attracting, developing, and retaining employees
- The measures, incentives, and rewards to drive accountability for performance

The auditor's assessment of the control environment should ordinarily include consideration of the entity's

- communication and enforcement of integrity and ethical values;
- commitment to competence;
- management philosophy and operating style;
- organizational structure;
- assignment of authority and responsibility; and
- human resource policies and practices

.30 *Communication and enforcement of integrity and ethical values:* The effectiveness of internal control cannot rise above the integrity and ethical values of the owner-manager who creates, administers, and monitors them. Integrity and ethical values are essential elements of the control environment that influence the design, administration, and monitoring of other components of internal control. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The following points of focus underscore the important characteristics of this principle and assist management in determining whether the principle is present and functioning effectively:

- Setting the tone at the top
- Establishing standards of conduct
- Evaluating adherence to standards of conduct
- Addressing deviations in a timely manner

.31 Management may *tell you* a great deal about their integrity and ethical values. They may even commit their *words* to a *written document*. Responses to inquiries and written policies are good, but compliance with ethical standards is best ensured by focusing on management's *actions* and how these actions affect the entity on a day to day basis.

.32 For management's integrity and ethical values to have a positive effect on the entity, the following ordinarily should exist:

- The business owner and management personally have high ethical and behavioral standards.
- These standards are communicated to company personnel. In a small business, this communication is often informal.
- The standards are reinforced.

.33 When observing and evaluating management's *actions*, be alert for the following:

- *Segregation of personal from business funds and activities*. Many small business owners mix their personal and business activities, for example, the company may pay the owner's credit card bills even if they contain nonbusiness expenditures. The auditor might consider the owner's attitude and the care with which he or she separates the personal from the business activities. It's not unusual for a business to pay the owner's credit card bills, but the more important question is "does the owner reimburse the company?" Owners who treat company assets as if they were personal assets set a bad example for employees who may be encouraged to do the same.
- *Dealing with signs of problems*. Consider how management deals with signs that problems exist, particularly when the cost of identifying and solving the problem could be high. For example, suppose a client became aware of a possible environmental contamination on their premises. How would they react? Would they try to hide it, deny its existence, or act evasively if asked about it, or would they actively seek out their auditor's advice or the advice of their attorney?
- *Removal or reduction of incentives and temptations*. Individuals may engage in dishonest, illegal, or unethical acts simply because the owner-manager gives them strong incentives or temptations to do

so. Removing or reducing these incentives and temptations can go a long way toward diminishing undesirable behavior.

The emphasis on results, particularly in the short term, fosters an environment in which the price of failure becomes very high. *Incentives* for engaging in fraudulent or questionable financial reporting practices include the following:

- — Pressure to meet unrealistic performance targets, particularly for short term results
  - High performance-dependent rewards
  - Upper and lower cutoffs on bonus plans

- *Temptations* for employees to engage in improper practices include the following:
  - — Nonexistent or ineffective controls, such as poor segregation of duties in sensitive areas that offer temptations to steal or conceal questionable financial reporting practices
  - — Owner-managers who are unaware of actions taken by employees
  - — Penalties for improper behavior that are insignificant or unpublicized and thus lose their value as deterrents

- *Management intervention*. There are certain situations where it is appropriate for management to intervene and overrule prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with nonrecurring and nonstandard transactions or events that otherwise might be handled by the financial reporting information system. The auditor might consider whether management has provided guidance on the situations and frequency with which intervention of established controls is appropriate. It is a best practice for management interventions to be documented and explained.

.34 *Commitment to competence*. Competence is the knowledge and skills necessary to accomplish tasks that define an individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

> ***Practical example:*** *Mrs. Jones has always kept the books for Jones Grocery. She is self-taught, with no formal training in accounting or bookkeeping. There are no plans to replace Mrs. Jones with someone more "qualified." As the auditor of Jones Grocery, you recognized the risk of having an untrained bookkeeper and design your audit approach to address such concerns by*
>
> *a. training Mr. and Mrs. Jones to call you whenever they have a transaction out of the ordinary;*
>
> *b. strongly encouraging Mrs. Jones to take training classes on the accounting software package used by the entity;*
>
> *c. explaining to Mrs. Jones the importance of key accounting records such as the accounts payable subledger and inventory reports; and*
>
> *d. teaching Mrs. Jones important basic control functions such as bank reconciliations.*

.35 *Management's philosophy and operating style*. Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles or conscientiousness and conservatism with which accounting estimates are developed.

.36 Management's philosophy and operating style have a significant influence on the control environment, particularly in a small business where the owner-manager dominates the organization, regardless of the consideration given to the other control environment factors. For example, the auditor may be concerned about the client's unduly aggressive attitude toward financial reporting. Not only might this cause the auditor to assess control risk as high for some or all assertions, but it may heighten concerns about irregularities affecting certain assertions.

.37 However, a dominant owner-manager does not necessarily cause the auditor to assess control risk as high.

> ***Practical example:*** *Mr. Jones dominates the management of Jones Grocery. He demonstrates a positive attitude toward the control environment and a moderate to conservative attitude toward accepting business risk such as expansion. He is more concerned about taxes than financial reporting. Mr. Jones uses information generated by the financial reporting information system to monitor the financial results of the company and compare it to prior periods. His review of the accounting reports encourages Mrs. Jones and others who help with the accounting to work with greater care. Mr. Jones also performs many control activities himself, such as the review and supervision of the physical inventory counts. Although Mr. Jones is concerned about his income tax liability, you might not view the possible bias to misstate income as a significant risk because of the otherwise positive control environment.*

.38 *Organizational structure*. A client's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and reviewed.

.39 Significant aspects of establishing a relevant organizational structure include considering key areas of authority and responsibility and appropriate lines of reporting. An entity develops an organizational structure suited to its needs. The appropriateness of an entity's organizational structure depends in part on its size and the nature of its activities. For example, small business entities usually have fairly simple organizational structures. A highly structured organization with formal reporting lines and responsibilities may be appropriate for large entities, but for a small business, this type of structure may impede the necessary flow of information.

.40 *Assignment of authority and responsibility*. The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

.41 Alignment of authority and accountability often is designed to encourage individual initiatives, within limits. Delegation of authority means surrendering central control of certain business decisions to lower echelons to the people who are closest to everyday business transactions.

.42 A critical challenge is to delegate only to the extent required to achieve objectives. This requires ensuring that risk acceptance is based on sound practices for identifying and minimizing risk, including sizing risks and weighing potential losses versus gains in arriving at good business decisions.

.43 Another challenge is ensuring that all personnel understand the entity's objectives. It is essential that each individual knows how his or her actions interrelate and contribute to achievement of the objectives.

> ***Practical example:*** *Mr. Jones had to decide how to delegate authority and responsibility when he expanded Jones Grocery from the one original store to its present eight store chain spread out over greater Anytown and the surrounding suburbs. One area that proved problematic was setting prices. Mr. Jones assumed that he would be able to set the prices at all of the stores, just like he did for his original store. He felt this was a good procedure because it allowed him some control over profit margins. Problems arose because the competitive pressures were different in different areas of the city. A competitor in the north suburb ran specials or lowered prices on certain items, and a competitor in the west suburb ran specials on different items. It became too difficult for Mr. Jones to keep up with the constantly changing price battles at eight different stores. He eventually delegated this responsibility to the individual store managers. He set a limit on how much a store manager could discount prices without his prior approval, but other than that, the store managers had the freedom to set prices to respond to the changing competitive environment.*
>
> *The responsibility for accounting information was also affected by Jones Grocery's expansion. Mr. Jones' original thought was that each store would be run as a separate business, with separate financial reporting information systems that would be consolidated together at the main store. Problems soon developed in several areas, most notably accounts payable. The store managers were responsible for entering vendor invoices into the computer system. But it seemed that no matter how much Mr. Jones threatened, cajoled, and begged his store managers to enter the invoices on a timely basis, they just*

couldn't do it consistently. The procedure had to be changed. Now, the store managers only have the responsibility to check incoming goods for quantity and condition. Vendor invoices are sent directly to Mrs. Jones at the main store, and she is responsible for maintaining the accounts payable for all the stores.

.44 The control environment is greatly influenced by the extent to which individuals recognize that they will be held accountable. This holds true all the way to the owner-manager, who has the ultimate responsibility for all activities within the organization, including internal control.

.45 *Human resource policies and practices*. Human resource policies and practices often demonstrate important matters regarding the entity's control consciousness and affect an entity's ability to hire employees possessing suitable skill, knowledge, or experience to accomplish its goals and objectives. Human resource policies and practices include an entity's policies and procedures for hiring, orienting, training, evaluating, counseling, promoting, compensating, and taking remedial action. In many small businesses, these policies may not be formalized but they can nevertheless exist and be communicated. The owner-manager can orally make explicit his or her expectations about the type of person to be hired to fill a particular job and may even be active in the hiring process. Formal documentation is not always necessary for a policy to be in place and operating effectively.

Practical example: *When Mr. and Mrs. Jones added a second store, the hiring of a store manager was easy—they hired their daughter. Adding a third store proved to be more problematic, because the other Jones children had no interest in the family business. Mr. and Mrs. Jones talked at length about the type of person they would hire as a store manager. They finally decided it was more important to hire someone they could trust, someone they felt comfortable with on a personal level rather than someone with an extensive background in the grocery business. They felt they could teach someone the grocery business but not how to be trustworthy. That hiring policy worked, and they've been following it ever since.*

.46 Standards for hiring the most qualified individuals, with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior, demonstrate an entity's commitment to competent and trustworthy people. Hiring practices that include formal in-depth employment interviews and informative and insightful presentations on the company's history, culture, and operating style send a message that the company is committed to its people.

.47 Personnel policies that communicate prospective roles and responsibilities and that provide training opportunities indicate expected levels of performance and behavior. Rotation of personnel and promotions driven by periodic performance appraisals demonstrate the entity's commitment to advancement of qualified personnel to higher levels of responsibility. Competitive compensation programs that include bonus incentives serve to motivate and reinforce outstanding performance. Disciplinary actions send a message that violations of expected behavior will not be tolerated.

.48 *Participation of those charged with governance*. An entity's control consciousness is significantly influenced by those charged with governance. Attributes include those charged with governance's independence from management, the experience and stature of its members, the extent of its involvement and scrutiny of activities, the appropriateness of its actions, the information it receives, the degree to which difficult questions are raised and pursued with management, and its interaction with internal and external auditors. The importance of responsibilities of those charged with governance is recognized in codes of practice and other regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle-blower procedures and of the process for reviewing the effectiveness of the entity's internal control.

.49 As defined in paragraph .06 of AU-C section 260, *those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the terms *board of directors* or *audit committee*.

.50 *Considerations specific to smaller, less complex entities*. The control environment within smaller entities is likely to differ from larger entities. For example, those charged with governance in smaller entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager when no other owners exist. The nature of the control environment also may influence the significance of other controls or their absence. For example, the active involvement of an owner-manager may mitigate certain risks arising from a lack of segregation of duties in a small entity; however, it may increase other risks (for example, the risk of override of controls). Please refer to paragraphs .82–.84 for additional discussion of how the participation of those charged with governance applies to medium and large businesses.

.51 A small business can have unique advantages in establishing a strong control environment. Employees in many smaller businesses interact more closely with top management and are directly influenced by management actions. Through day-to-day practices and actions, management can effectively reinforce the company's fundamental values and directives. The close working relationship also enables senior management to quickly recognize when employees' actions need modification.

The Client's Risk Assessment Process

.52 Risk is defined in the framework as "the possibility that an event will occur and adversely affect the achievement of objectives." Risk assessment, as it relates to the objective of reliable financial reporting, involves identification and analysis of the risks of material misstatement. Although risk assessment may seem to be a complex process, it can be summarized into the following steps:

1. Identify potential causes of failing to achieve objectives
2. Assess the likelihood that such causes will occur
3. Evaluate the effect of risk on achievement of the objectives
4. Consider the degree to which the risk can be managed

Establishment of financial reporting objectives articulated by a set of financial statement assertions for significant accounts is a precondition to the risk assessment process. Risk assessment in small businesses can be relatively efficient, often because in-depth knowledge of the company's operations enables the owner and management to have firsthand information of where risks exist. In carrying out their normal responsibilities, including obtaining information gained from employees, customers, suppliers, and others, these managers identify risks inherent in business processes. In addition to focusing on operations and compliance risks, they are positioned to consider the following risks to reliable financial reporting:

- Failing to capture and record all transactions
- Recording assets that do not exist or transactions that did not occur
- Recording transactions in the wrong period or wrong amount or misclassifying transactions
- Losing or altering transactions once recorded
- Failing to gather pertinent information to make reliable estimates
- Recording inappropriate journal entries
- Improperly accounting for transactions or estimates
- Inappropriately applying formulas or calculations

.53 Risks relevant to financial reporting include events and circumstances that may adversely affect the company's ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. Risks can arise or change due to circumstances such as the following:

- *Changes in the operating environment*. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.

- *New personnel*. New personnel may have a different focus on or understanding of internal control. When people change jobs or leave the company, management generally should consider the control activities they performed and who will perform them going forward. Steps ordinarily should be taken to ensure new personnel understand their tasks.
- *New or revamped information systems*. Significant and rapid changes in information systems can change the risk relating to internal control. When these systems are changed, management generally should assess how the changes will impact control activities. Are the existing activities appropriate or even possible with the new systems? Personnel should be adequately trained when information systems are changed or replaced.
- *Rapid growth*. Significant and rapid expansion of operations can strain internal control and increase the risk of a breakdown in internal control. Management generally should consider whether accounting and information systems are adequate to handle increases in volume.
- *New technology*. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities*. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Corporate restructurings*. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations*. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control (for example, additional or changed risks from foreign currency transactions).
- *New accounting pronouncements*. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

.54 Once risks are identified, management generally considers their significance, the likelihood of their occurrence, and how they should generally be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations.

.55 The auditor's procedures to assess whether a client's risk assessment process is placed in operation may consist of inquiry. For example, you may ask accounting personnel what accounts they believe are the most difficult to become satisfied with as they prepare the financial statements. You may also consider asking the same questions of personnel outside the accounting department. However, inquiry alone is not sufficient to determine whether the client has implemented a risk assessment process. When inquiry is used to obtain information about the client's risk assessment process, the auditor should corroborate the responses to his or her inquiries by performing at least one other risk assessment procedure to determine that the client is using the risk assessment process as intended. That additional procedure may be further observations of the risk assessment process operating or inspecting documents and reports.

Control Activities

.56 Control activities are the tools used by an entity to mitigate risks and consist of policies and procedures established by management. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties. There is no "one size fits all" solution to control activities. Because entities operate in a myriad of different circumstances, the control activities needed to mitigate risks to operating, reporting, and compliance objectives will vary tremendously. Smaller entities may employ a different set of control activities as compared to larger entities. For example, when resource constraints compromise the ability to segregate duties, in smaller companies they may use certain compensating controls to achieve the objectives.

.57 At the entity-wide level, control activities may be categorized as policies and procedures that pertain to the following:

- *Performance reviews*. These control activities include reviews of actual performance versus budgets, forecasts, and prior period performance. They may also involve relating different sets of data (for example, operating or financial) to one another, together with analyses of the relationships, investigating unusual relationships and taking corrective action. Performance reviews may also include a review of functional or activity performance.
- *Information processing*. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records; maintaining and reviewing accounts and trial balances; automated controls, such as edit checks of input data and numerical sequence checks; and manual follow-up of exception reports. Examples of general IT controls are program change controls; controls that restrict access to programs or data; controls over the implementation of new releases of packaged software applications; and controls over system software that restrict access to, or monitor the use of, system utilities that could change financial data or records without leaving an audit trail. These controls are discussed in more detail in paragraphs .89–.93.
- *Physical controls*. This includes controls that encompass the
  - physical security of assets, including adequate safeguards, such as secured facilities over access to assets and records.
  - authorization for access to computer programs and data files.
  - periodic counting and comparison with amounts shown on control records (for example comparing the results of cash, security, and inventory counts with accounting records).

  The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation and, therefore, the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.
- *Segregation of duties*. Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties. See paragraphs .110–.117 for further discussion and guidance.

Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, nonroutine transactions, such as major acquisitions or divestments, may require specific high level approval, including, in some cases, that of shareholders.

.58 The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

.59 *Considerations specific to smaller, less complex entities*. The concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, smaller entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

General IT Controls

.60 General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data center and network operations
- System software acquisition, change, and maintenance
- Program change
- Access security
- Application system acquisition, development, and maintenance

General IT controls are generally implemented to deal with the risks referred to in paragraph .A57 of AU-C section 315.

.61 Although ineffective general IT controls do not by themselves cause misstatements, they may permit application controls to operate improperly and allow misstatements to occur and not be detected. For example, if deficiencies in the general IT controls over access security exist and applications are relying on these general controls to prevent unauthorized transactions from being processed, such general IT control deficiencies may have a more severe effect on the effective design and operation of the application control. General IT controls are assessed with regard to their effect on applications and data that become part of the financial statements. For example, if no new systems are implemented during the period of the financial statements, deficiencies in the general IT controls over application system acquisition and development may not be relevant to the financial statements being audited.

Application Controls

.62 Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, authorize, record, process, and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

.63 The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process and when they include effective general IT controls and application controls.

Information and Communication Systems

.64 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to

- initiate, authorize, record, process, and report entity transactions (as well as events and conditions) and maintain accountability for the related assets, liabilities, and equity;
- resolve incorrect processing of transactions (for example, automated suspense files and procedures followed to clear suspense items out on a timely basis);
- process and account for system overrides or bypasses to controls;
- transfer information from transaction processing systems to the general ledger;

- capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.

.65 An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

.66 An entity's financial reporting process also includes the use of nonstandard journal entries to record nonrecurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or nonrecurring estimates, such as the impairment of an asset. In manual general ledger systems, nonstandard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may, therefore, be more easily identified through the use of computer assisted audit techniques.

.67 An entity's business processes are the activities designed to

- develop, purchase, produce, sell, and distribute an entity's products and services;
- ensure compliance with laws and regulations; and
- record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed, and reported by the information system. Obtaining an understanding of the entity's business processes, which includes how transactions are originated, assists the auditor to obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

.68 *Considerations specific to smaller, less complex entities*. Information systems and related business processes relevant to financial reporting in smaller entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Smaller entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may, therefore, be easier in an audit of smaller entities, and it may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

.69 An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Many information systems make extensive use of IT. The information system relevant to financial reporting objectives, which includes the accounting system, encompasses methods and records that

- 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.

.70 The quality of system generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports. Thus, it is important that management receives the information they need to carry out their responsibilities and that the information is provided at the right level of detail.

.71 The financial reporting information system is an integral part of an entity's information and communication system. The auditor's consideration of the system may often be made at the individual account and classes of transaction level.

.72 The communication component of an entity's internal control involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management. Open communication channels help ensure that exceptions are reported and acted on.

.73 *Considerations specific to smaller, less complex entities*. Effective internal communication between top management and employees in smaller companies may be less structured and facilitated due to fewer levels of responsibility, fewer personnel, and greater visibility and availability of the owner. Internal communication can take place through frequent meetings and day-to-day activities in which the owner and other managers participate.

.74 When obtaining an understanding of how the incorrect processing of transactions is resolved, such understanding might include, among other considerations, whether there is an automated suspense file, how it is used by the entity to ensure that suspense items are cleared out on a timely basis, and how system overrides or bypasses to controls are processed and accounted for.

Monitoring

.75 Monitoring of controls is a process to assess the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities often are built into the normal recurring activities of an entity and include regular management and supervisory activities

.76 An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring also is done to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

.77 Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control; communicate information about strengths and deficiencies in internal control; and provide recommendations for improving internal control.

.78 Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control (for example, communications concerning examinations by bank regulatory agencies). Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

.79 Examples of ongoing monitoring activities include the following:

- Management reviews of data produced by the entity's information system. Managers are in touch with operations and may question reports that differ significantly from their knowledge of operations. However, management generally should have a basis for believing the data is accurate. If errors exist in the information, management may make incorrect conclusions from its monitoring activities.
- Communications from external parties corroborate internally generated information or indicate problems. Customers implicitly corroborate billing data by paying their invoices. Conversely, customer complaints about billings could indicate system deficiencies in the processing of sales transactions. Similarly, bankers, regulators, or other outside parties may communicate with the company on matters of accounting significance.
- External auditors regularly provide recommendations on the way internal control can be strengthened. Auditors may identify potential weaknesses and make recommendations to management for corrective action.
- Employees may be required to sign off to evidence the performance of critical control functions. The sign-off allows management to monitor the performance of these control functions.

.80 *Considerations specific to smaller, less complex entities*. Management's monitoring of controls often is accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

Application to Medium and Large Businesses

.81 The control environments of medium to large businesses may differ from those of small business entities in the following ways:

- The presence of a board of directors or audit committee
- The presence of an internal audit function
- More formalized policies and procedures

Board of Directors or Audit Committee

.82 The control consciousness of a medium or large business is influenced significantly by those charged with governance. As defined previously, those charged with governance means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. Those charged with governance encompasses the term *board of directors* and *audit committee* used elsewhere in this section. Because of its importance, an active and involved board of directors—possessing an appropriate degree of management, technical, and other expertise coupled with the necessary stature and mind-set so that it can adequately perform the necessary governance, guidance, and oversight responsibilities—is critical to effective internal control.

.83 Factors that influence the effectiveness of those charged with governance include the following:

- Its independence from management
- The experience and stature of its members
- The extent of its involvement and scrutiny of activities
- The appropriateness of its actions
- The degree to which difficult questions are raised and pursued with management
- Its interaction with internal and external auditors

.84 The board of directors must be prepared to question and scrutinize management's activities, present alternative views and have the courage to act in the face of obvious wrongdoing. Because of this, it is necessary that the board contain at least a critical mass of outside directors. The number should suit the entity's circumstances, but more than one outside director normally would be needed for a board to have the requisite balance.

Internal Audit Function

.85 The internal audit function is established within an entity to monitor and evaluate the adequacy and effectiveness of internal control. For entities with an internal audit function, the auditor ordinarily should make inquiries of appropriate management and internal audit personnel about the internal auditors'

- organizational status within the entity;
- application of professional standards;
- audit plan, including the nature, timing, and extent of audit work; and
- access to records and any limitations on the scope of their activities.

In addition, the auditor might inquire about the internal audit function's charter, mission statement, or similar directive from management or those charged with governance. This inquiry will normally provide information about the goals and objectives established for the internal audit function.

Guidance Update

In February 2014, Statement on Auditing Standard (SAS) No. 128, *Using the Work of Internal Auditors* (AICPA, *Professional Standards* AU-C sec. 610), was issued as part of the AICPA's Clarity Project to supersede AU-C section 610A. SAS No. 128 addresses the external auditor's responsibilities if using the work of internal auditors. Using the work of internal auditors includes (*a*) using the work of the internal audit function in obtaining audit evidence and (*b*) using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor. SAS No. 128 requires, among other things, that as a prerequisite to being able to use the work of the internal audit function, the external auditor evaluate the application by the internal audit function of a *systematic and disciplined approach*, including quality control. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the existence, adequacy, and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation, and reporting, the nature and extent of which is commensurate with the nature and size of the internal audit function relative to the complexity of the entity. Another factor that may be considered is whether the internal audit function has appropriate quality control policies and procedures or quality control requirements in standards set by relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements, such as conducting periodic external quality assessments. The ASB believes that relative to SAS No. 65, this requirement represents an additional and explicit evaluation that the external auditor is required to perform to conclude on the appropriateness of using the work of internal auditors in obtaining audit evidence. SAS No. 128 is effective for audits of financial statements for periods ending on or after December 15, 2014.

.86 After obtaining an understanding of the internal audit function, the auditor may either

- conclude that the internal auditors' activities are not relevant to the financial statement audit and give no further consideration to the internal audit function;
- identify relevant internal auditor activities but conclude that it would not be efficient to further consider the work of the internal auditors; or
- decide that it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of the audit. In this case, you should assess the competence and objectivity of the internal audit function as outlined in paragraphs .09–.11 of AU-C section 610A.

.87 You may also request direct assistance from the internal auditors. Paragraph .27 of AU-C section 610A provides guidance for auditors when using internal auditors to provide direct assistance in performing the audit.

Formal Policies

.88 Medium and large businesses may communicate their policies in formal, written documents. For example, they may have a written code of conduct or human resource policies. The existence of formal policy documents is good, but as an auditor, your primary consideration is how the policies are implemented.

Computer Applications

.89 Small business entities are typically characterized by the use of off the shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

Practical example: *Jones Grocery has a stand-alone, state-of-the-art PC at its main store. One other store has a computer—an Apple Macintosh that Mr. and Mrs. Jones' daughter used at college. The PC at the main store is used to run the accounting software, which is an off the shelf product developed specifically for independent grocers. The payroll is processed by an outside payroll service.*

.90 In gaining an understanding of how computers are used in the business, the auditor may consider the following:

- The acquisition of hardware and software
- Physical access
- Logical access
- User controls over outsider service bureau applications

Acquisition of Hardware and Software

.91 Companies ordinarily should take steps to ensure they have compatible hardware and software. The use of compatible software reduces the risk of error, because there will be no need to transfer data from one format into another. Even small businesses generally should have a coherent plan for the purchase of computer hardware and software. If the business is growing, management will typically plan for the upgrade of the processor, random access memory (RAM), or hard disk storage.

Practical example: *Mr. and Mrs. Jones did not plan for the purchase of their computers. For several years, Mrs. Jones processed the accounting applications on an old PC with limited RAM and hard-disk storage. When the Jones' daughter opened the second store, she brought with her the Apple Macintosh she had in college. At first, she tried to transfer data from her store to the main store, but the software had problems converting from the Apple format, so the procedure was abandoned. At a trade show, Mr. Jones discovered a computer software program specifically designed for independent grocers. He was impressed with the program and decided that it fit his needs perfectly. However, his hardware was out of date, and so in order to run the software, he upgraded his hardware. The new software supposedly is able to handle Apple-formatted data, and the company has plans to transfer data from the second store electronically. There are no plans to install computers at the other stores.*

As the auditor of Jones Grocery, you should use this understanding of the company computer system to help plan the audit. For example, they plan to transfer data from the Apple to the PC. What other sorts of errors might occur in the transfer? What steps has the client taken to prevent or detect those errors? You also know that stores three through eight are on a manual system. What types of errors might occur in a manual system? What is the risk that those errors will occur?

.92 Entities ordinarily should also establish policies and procedures to mitigate the risk of computer viruses being introduced into their systems. Viruses can cause the loss of data and programs. A virus has the ability to attach itself to a program and infect other programs and systems. Although some viruses merely write messages across the screen, others can cause serious damage to disk files or shut down a network by replicating themselves millions of times and filling all available memory or disk storage.

.93 Methods to prevent the introduction of viruses and to recover from a virus attack include the following:

- Obtaining recognized software from reputable sources and only accepting delivery of the software in the manufacturer's sealed package.
- Making multiple generations of backups. A virus that is not detected initially may be copied onto more recent backup copies, and the older versions may not be infected.
- Prohibiting the use of unauthorized programs introduced by employees.
- Prohibiting the downloading of untested software from sources such as dial-up bulletin boards.
- Using virus protection software to screen for virus infections.

Physical Security

.94 Physical security—primarily backup and contingency planning—often is ignored by small businesses in a microcomputer environment. Poor backup procedures can result in the loss of important data that are very difficult, time consuming, and costly to recreate, if they can be recreated at all.

.95 Clients generally should have established procedures for the periodic backup of data files and applications. Critical applications and files ordinarily should be stored off-site with corresponding documentation in the event that on-site files become unavailable.

Logical Access

.96 Logical access to computer applications and data files may not be formally or rigorously controlled in a small business. This leaves the company exposed to the risk that files could be inappropriately manipulated or unauthorized transactions entered into the system. For example, without logical access controls a user may be able to enter any or all sections of a general ledger or other financial module and perform file maintenance such as changing the address of an accounts receivable customer or data used to calculate payroll.

.97 Management ordinarily should identify confidential and sensitive data for which access should be restricted. Mechanisms such as password control or the use of menus can be used to limit the access to that data.

.98 In a microcomputer environment, password control may be installed over the operating system using a shell program to prevent the user from accessing menu options of a program. Even if such a restriction exists, a sophisticated user can often bypass the shell by using a utility. Therefore, the use of utility programs generally should be controlled or monitored carefully.

User Controls Over Computer Service Organization Applications

.99 Entities may use an outside computer service organization to process significant accounting information. AU-C section 402 establishes requirements and provides guidance for auditors auditing entities that use computer service organizations.

.100 When using an outside computer service organization, most small businesses typically retain the responsibility for authorizing transactions and maintaining the related accountability. The computer service organization merely records user transactions and processes the related data. In these circumstances, the user (the small business) typically maintains controls over the input and output to prevent or detect material misstatement. When the service organization initiates, executes, and does the accounting processing of the user organization's transactions, it may not be practicable for the user organization to implement effective controls for those transactions.

.101 It is important that the entity have strong controls over communication with outsourced service providers because the interdependence of business processes between the entity and outsourced service providers can blur the lines of responsibility. Communicating with outsourced service providers responsible for activities supporting the entity's objectives may facilitate the risk assessment process, the oversight of business activities, decision making, and the identification of responsibility for internal control throughout the process regardless of where activities occur. For example, it is necessary that management communicate a requirement to the outsourced service provider to provide Service Organization Control Reports® reports as soon as they are available to assist the entity in evaluating the effectiveness of relevant internal controls at the outsourced service providers.

Practical example: *Jones Grocery uses an outside computer service to process payroll. Time cards are gathered for each store and reviewed by the store manager before being sent to the main store. Mrs. Jones reviews the time cards for the store managers and checks to make sure all personnel have submitted time cards for the pay period. All other payroll transactions such as pay rates, withholdings, and benefits, among others, are sent directly to Mrs. Jones. She forwards all information to the payroll service, which prepares the checks and produces a payroll register. Mrs. Jones reviews the register and checks for any obvious misstatements before she distributes the checks.*

Application to Medium or Large Businesses

.102 Medium and large businesses typically have more complicated computer processing systems than small businesses. They also tend to use the computer for a greater amount of processing. For example, a small business may prepare customer invoices manually by looking up prices on a master price list. A medium size business may maintain master price information on a computer file and use the computer to generate packing slips, sales invoices, and reports of unmatched documents.

.103 Medium and large businesses are also typically characterized by a separate management information services department with formally defined job descriptions and responsibilities.

.104 Instead of using off the shelf, unmodified software, the medium or large business will modify standard software or develop its own applications. Its software may be more complicated than that used by the small business; for example, the medium or large business may use a database management system or telecommunications software.

.105 Medium and large businesses often use a mainframe computer in conjunction with microcomputers or a local area microcomputer network. Information is frequently transferred between the mainframe and microcomputers that may be located on-site or at a remote location.

.106 Control activities in a computerized environment generally comprise a combination of the following:

- User control activities
- Programmed control activities and manual follow-up
- Computer general control activities

.107 *User controls*. User control activities are manual checks of the completeness and accuracy of computer output against source documents or other input. For example, an entity may have programmed procedures in a billing system that calculates sales invoice amounts from shipping data and master price files. The entity may also have a procedure to manually check the completeness and accuracy of the invoices. In many systems, user controls relate only to the completeness of records and not to the accuracy of processing.

.108 *Programmed control activities and manual follow-up activities*. Programmed control activities are those that are built into the computer processing program; for example, the generation of an exception report. However, an exception report is useless unless the client follows up on the items listed. Thus, in addition to understanding the nature of the programmed control activities, the auditor may also obtain an understanding of the related manual follow-up procedures.

.109 *Computer general control activities*. If computer general control activities operate effectively, there is greater assurance that programmed control activities are properly designed and function consistently throughout the period. The auditor may plan to understand computer general control activities to provide evidence that

- programs are properly designed and tested in development;
- changes to programs are properly made;
- computer operations ensure the proper use of application programs and data files; and
- adequate access controls reduce the risk of unauthorized changes to the program and data files.

.110 The following table summarizes computer general control activities.

Area	*Control Objectives*	*Example Controls*
Program development	• Controls ensure that new applications systems are suitably authorized, designed, and tested	• Users are involved in the design and approval of systems • Checkpoints where users review the completion of various phases of the application • Development of test data and testing of the program • User involvement in the review of tests of the program • Adequate procedures to transfer programs from development to production libraries
Program changes	• Controls over changes to existing programs and systems ensure that modifications to application programs are suitably approved, designed, tested, and implemented	• Same as program development • User involvement • Adequate testing • Adequate transfer activities • Segregation of duties between programmers and production libraries
Computer operations	• Controls ensure that application programs are used properly and that proper data files are used during processing	• Review of lists of regular and unscheduled batch jobs by operations management • Use of menu-driven job control instruction sets • Jobs executed only from the operator's terminal • Adequate procedures for managing and backing up data and program files

(continued)

Area	*Control Objectives*	*Example Controls*
Access	• Controls should prevent or detect unauthorized changes to programs and to data files supporting the financial statements	• Programmers have limited access to production programs, live data files, and job control language • Operators have limited access to source code and individual elements of data files • Users have access only to defined programs and data files

Segregation of Duties and Management Override

.111 Small businesses are typically characterized by the following:

- A dominant owner-manager
- A lack of segregation of duties

.112 These characteristics may pose unique risks to the entity.

.113 Duties generally should be divided among different people to reduce the risks of error or inappropriate actions. For instance, responsibilities for authorizing transactions, recording them, and handling the related assets could be divided.

.114 Even small businesses with only a few employees can usually parcel out responsibilities to achieve the necessary checks and balances. If that is not possible—which may be the case on occasion—direct oversight of the incompatible activities by the owner-manager can provide the necessary control. Thus, a dominant owner-manager may be a positive element in the design of internal control.

.115 A dominant owner-manager may be a negative element in the design of internal control when he or she is able to override established policies and procedures.

.116 Management *override* is different from management *intervention*. *Management intervention* is discussed in paragraph .33 and is described as the overrule of internal control for legitimate purposes. For example, management intervention is usually necessary to deal with nonrecurring and nonstandard transactions or events that otherwise might be handled by the system.

.117 In contrast, *management override* is the overrule of internal control for illegitimate purposes with the intent of personal gain or enhanced presentation of an entity's financial condition or compliance status.

.118 An owner-manager might override internal control for many reasons:

- To increase or decrease reported revenue
- To boost fair value of the entity prior to sale
- To meet sales or earnings projections
- To bolster bonus pay-outs tied to performance
- To appear to cover violations of debt covenant agreements
- To hide lack of compliance with legal requirements

Override practices include deliberate misrepresentations to bankers, lawyers, accountants, and vendors, as well as intentionally issuing false documents such as sales invoices.

Evaluation and Communication of Deficiencies

Assess Results

.119 After completing the ongoing or separate evaluation, management may identify matters requiring attention, including an internal control deficiency (a potential or real shortcoming, in some aspect of the system of internal control that has the potential to adversely affect the ability of the entity to achieve its objectives). Additionally, management may identify opportunities to improve the entity's internal control system.

Communicating Internal Control Deficiencies

.120 For remediation purposes, internal control deficiencies should be communicated on a timely basis to the proper parties. The nature of matters to be communicated varies depending on how the deficiency is evaluated against appropriate criteria, individuals' authority to deal with circumstances that arise, and the oversight activities of superiors. After deficiencies are identified and evaluated, management is responsible for tracking whether remediation efforts are conducted on a timely basis.

.121 Deficiencies should be reported at a sufficiently high level to drive appropriate action. For example, if the board of directors has no independent directors, the deficiencies would be reported to the full board (typical in smaller entities).

.122 Finally, the entity is responsible for considering whether a deficiency affects a compliance objective and the entity may need to report the deficiency externally depending on the type of entity and the regulatory, industry, or other compliance requirements. For example, a significant internal control deficiency at a not-for-profit entity may need to be reported to government agencies if the entity receives government funds.

[*The next page is 5001.*]

AAM Section 5000
Designing and Performing Further Audit Procedures

The material included in these sections on designing and performing further audit procedures is presented for illustrative purposes only. The nature, extent, and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the assessed risks of material misstatement.

This manual is a nonauthoritative practice aid. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate. Please also note that this manual does not deal with specialized industry issues; refer to applicable AICPA Audit and Accounting Guides for industry guidance.

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AAM Section 5100

Audit Evidence and Designing Further Audit Procedures

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*
- AU-C section 230, *Audit Documentation*
- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 450, *Evaluation of Misstatements Identified During the Audit*
- AU-C section 500, *Audit Evidence*
- AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items*
- AU-C section 505, *External Confirmations*
- AU-C section 520, *Analytical Procedures*
- AU-C section 580, *Written Representations*

Sufficient Appropriate Audit Evidence

.01 The auditor should design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

.02 Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources, such as previous audits (provided that the auditor has determined whether changes have occurred since the previous audits that may affect its relevance to the current audit, or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of management's specialist. Audit evidence comprises both information that supports and corroborates management's assertions and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor and, therefore, also constitutes audit evidence.

.03 Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance, and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor is inquiry alone sufficient to test the operating effectiveness of controls.

.04 As explained in AU-C section 200, reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

.05 The sufficiency and appropriateness of audit evidence are interrelated. *Sufficiency* is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). However, obtaining more audit evidence may not compensate for its poor quality.

.06 *Appropriateness* is the measure of the quality of audit evidence (that is, its relevance and reliability in providing support for the conclusions on which the auditor's opinion is based). The reliability of evidence is influenced by its source and nature and is dependent on the individual circumstances under which it is obtained.

.07 AU-C section 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level and, thereby, enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. AU-C section 200 contains discussion of relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

Sources of Audit Evidence

.08 Some audit evidence is obtained by performing audit procedures to test the accounting records (for example, through analysis and review, by reperforming procedures followed in the financial reporting process, and by reconciling related types and applications of the same information). Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements. However, accounting records alone do not provide sufficient appropriate audit evidence on which to base an audit opinion on the financial statements.

.09 More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance that the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

.10 Information from sources independent of the entity that the auditor may use as audit evidence include confirmations from third parties, analysts' reports, and comparable data about competitors (benchmarking data).

Audit Procedures for Obtaining Audit Evidence

.11 As required by and explained further in AU-C section 315 and AU-C section 330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing the following:

a. Risk assessment procedures

b. Further audit procedures, which comprise

   i. tests of controls, when required by the AU-C sections or when the auditor has chosen to do so, and

   ii. substantive procedures, which include tests of details and substantive analytical procedures.

.12 The audit procedures described in paragraphs .A14–.A26 of AU-C section 500 (discussed in the following paragraphs) may be used as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor. As explained in AU-C section 330, audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence, provided that the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit.

.13 The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

.14 Certain electronic information may not be retrievable after a specified period of time (for example, if files are changed and if backup files do not exist). Accordingly, the auditor may find it necessary, as a result of an entity's data retention policies, to request retention of some information for the performance of audit procedures at a later point in time or to perform audit procedures at a time when the information is available.

Inspection

.15 Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

.16 Some documents represent direct audit evidence of the existence of an asset (for example, a document constituting a financial instrument such as a stock or bond). Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

.17 Inspection of tangible assets may provide reliable audit evidence with respect to their existence but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting. For example, when observing an inventory count, the auditor may inspect individual inventory items (such as opening containers included in the inventory count to determine whether they are full or empty) to verify their existence.

Observation

.18 Observation consists of looking at a process or procedure being performed by others (for example, the auditor's observation of inventory counting by the entity's personnel or the performance of control activities). Observation provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed. AU-C section 501 addresses observation of the counting of inventory.

External Confirmation

.19 An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party) in paper form or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, their relevant details. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions (for example, the absence of a side agreement that may influence revenue recognition). AU-C section 505 establishes requirements and provides guidance regarding the auditor's use of external confirmation procedures to obtain audit evidence, in accordance with the requirements of AU-C section 330 and AU-C section 500.

Recalculation

.20 Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

.21 Reperformance involves the independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Analytical Procedures

.22 Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations and relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. AU-C section 520 establishes requirements and provides guidance regarding the auditor's use of analytical procedures as substantive procedures. It also addresses the auditor's responsibility to perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

.23 *Scanning* is a type of analytical procedure involving the auditor's exercise of professional judgment to review accounting data to identify significant or unusual items to test. This may include the identification of unusual individual items within account balances or other data through the reading or analysis of, for example, entries in transaction listings, subsidiary ledgers, general ledger control accounts, adjusting entries, suspense accounts, reconciliations, and other detailed reports. Scanning may include searching for large or unusual items in the accounting records (for example, nonstandard journal entries), as well as in transaction data (for example, suspense accounts and adjusting journal entries) for indications of misstatements that have occurred. Electronic audit procedures may assist the auditor in identifying unusual items. When the auditor selects items for testing by scanning and those items are tested, the auditor obtains audit evidence about those items. The auditor's scanning also may provide some audit evidence about the items not selected for testing because the auditor has exercised professional judgment to determine that the items not selected are less likely to be misstated.

.24 Additional discussion on analytical procedures is provided in section 3155, "Analytical Procedures." Also, paragraphs .A7–.A10 of AU-C section 315 (discussed in section 3155) provides guidance on analytical procedures performed as risk assessment procedures. Section 5300, "Performing Substantive Procedures," provides additional discussion on substantive analytical procedures.

Inquiry

.25 Inquiry consists of seeking information of knowledgeable persons, both financial and nonfinancial, within the entity or outside the entity. Inquiry is used extensively throughout the audit, in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

.26 Inquiry normally involves such actions as the following:

- Considering the knowledge, objectivity, experience, responsibility, and qualifications of the individual to be questioned
- Asking clear, concise, and relevant questions

- Using open or closed questions appropriately
- Listening actively and effectively
- Considering the reactions and responses and asking follow-up questions
- Evaluating the response

See appendix K, "Suggestions for Conducting Inquiries," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* for further guidance on performing inquiries.

.27 Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained (for example, information regarding the possibility of management override of controls). In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

.28 Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

.29 In some instances, the auditor may need to obtain evidence about management's intended actions, for example, when obtaining evidence to support management's classification of investments as either trading, available for sale, or hold to maturity. To corroborate management's responses to questions regarding their intended future action, the following may provide relevant information:

- Management's past history of carrying out its stated intentions with respect to assets and liabilities
- Management's stated reasons for choosing a particular course of action
- Management's ability to pursue a specific course of action

.30 Regarding some matters, the auditor may consider it necessary to obtain written representations from management and, when appropriate, those charged with governance to confirm responses to oral inquiries. AU-C section 580 establishes requirements and provides guidance regarding the auditor's responsibility to obtain written representations from management and, when appropriate, those charged with governance in an audit of financial statements.

Information to Be Used as Audit Evidence

.31 When designing and performing audit procedures, the auditor should consider the relevance and reliability of the information to be used as audit evidence.

Relevance and Reliability

.32 As noted in paragraph .A1 of AU-C section 500, although audit evidence is primarily obtained from audit procedures performed during the course of the audit, it also may include information obtained from other sources (for example, previous audits, in certain circumstances, and a firm's quality control procedures for client acceptance and continuance). The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance

.33 Relevance relates to the logical connection with, or bearing upon, the purpose of the audit procedure and, when appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

.34 A given set of audit procedures may provide audit evidence that is relevant to certain assertions but not others. For example, inspection of documents related to the collection of receivables after the period-end may provide audit evidence regarding existence and valuation but not necessarily cutoff. Similarly, obtaining audit evidence regarding a particular assertion (for example, the existence of inventory) is not a substitute for obtaining audit evidence regarding another assertion (for example, the valuation of that inventory). On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

.35 Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control and identifying deviation conditions that indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

.36 Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

Reliability

.37 The reliability of information to be used as audit evidence and, therefore, of the audit evidence itself is influenced by its source and nature and the circumstances under which it is obtained, including the controls over its preparation and maintenance, when relevant. Therefore, generalizations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. Information obtained from an independent external source may not be reliable, for example, if the source is not knowledgeable or a management specialist lacks objectivity. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies, facsimiles, or documents that have been filmed, digitized, or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

.38 Section 5300 provides additional discussion on substantive analytical procedures.

.39 AU-C section 240 addresses circumstances in which the auditor has reason to believe that a document may not be authentic or may have been modified without that modification having been disclosed to the auditor.

.40 If information to be used as audit evidence has been prepared using the work of a management's specialist, the auditor should, to the extent necessary, taking into account the significance of that specialist's work for the auditor's purposes

a. evaluate the competence, capabilities, and objectivity of that specialist;

b. obtain an understanding of the work of that specialist; and

c. evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion.

Reliability of Information Produced by a Management's Specialist

.41 The preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity uses a management's specialist in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement and may be a significant deficiency or material weakness.

.42 When information to be used as audit evidence has been prepared using the work of a management's specialist, the requirement in paragraph .08 of AU-C section 500 applies. For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which no observable market exists. If the individual or organization applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organization is a management's specialist and paragraph .08 of AU-C section 500 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph .07 of AU-C section 500, but it is not the use of a management's specialist by the entity.

.43 The nature, timing, and extent of audit procedures with regard to the requirement in paragraph .08 of AU-C section 500 may be affected by such matters as the following:

- The nature and complexity of the matter to which the management's specialist relates
- The risks of material misstatement of the matter
- The availability of alternative sources of audit evidence
- The nature, scope, and objectives of the work of the management's specialist
- Whether the management's specialist is employed by the entity or is a party engaged by it to provide relevant services
- The extent to which management can exercise control or influence over the work of the management's specialist
- Whether the management's specialist is subject to technical performance standards or other professional or industry requirements
- The nature and extent of any controls within the entity over the work of the management's specialist
- The auditor's knowledge and experience of the field of expertise management's specialist
- The auditor's previous experience of the work of that specialist

The Competence, Capabilities, and Objectivity of a Management's Specialist

.44 Competence relates to the nature and level of expertise of the management's specialist. Capability relates to the ability of the management's specialist to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest, or the influence of others may have on the professional or business judgment of the management's specialist. The competence, capabilities, and objectivity of a management's specialist, and any controls within the entity over that specialist's work, are important factors with regard to the reliability of any information produced by a management's specialist.

.45 Information regarding the competence, capabilities, and objectivity of a management's specialist may come from a variety of sources, such as the following:

- Personal experience with previous work of that specialist
- Discussions with that specialist
- Discussions with others who are familiar with that specialist's work
- Knowledge of that specialist's qualifications, membership in a professional body or industry association, license to practice, or other forms of external recognition
- Published papers or books written by that specialist
- An auditor's specialist, if any, that assists the auditor in obtaining sufficient appropriate audit evidence with respect to information produced by the management's specialist

.46 Matters relevant to evaluating the competence, capabilities, and objectivity of a management's specialist include whether that specialist's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

.47 Other matters that may be relevant include

- the relevance of the capabilities and competence of the management's specialist to the matter for which that specialist's work will be used, including any areas of specialty within that specialist's field. For example, a particular actuary may specialize in property and casualty insurance but have limited expertise regarding pension calculations.
- the competence of the management's specialist with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models, when applicable, that are consistent with the applicable financial reporting framework.
- whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities, and objectivity of the management's specialist as the audit progresses.

.48 A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats, and intimidation threats. Safeguards may reduce such threats and may be created either by external structures (for example, the profession, legislation, or regulation of the management's specialist) or by the work of the management's specialist environment (for example, quality control policies and procedures).

.49 Although safeguards cannot eliminate all threats to the objectivity of a management's specialist, threats such as intimidation threats may be of less significance to a specialist engaged by the entity than to a specialist employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, a specialist employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

.50 When evaluating the objectivity of a specialist engaged by the entity, it may be relevant to discuss with management and that specialist any interests and relationships that may create threats to the specialist's objectivity and any applicable safeguards, including any professional requirements that apply to the specialist, and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include the following:

- Financial interests
- Business and personal relationships
- Provision of other services

Obtaining an Understanding of the Work of the Management's Specialist

.51 An understanding of the work of the management's specialist includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of the management's specialist, or whether the auditor needs an auditor's specialist for this purpose.

.52 Aspects of the field of the management's specialist relevant to the auditor's understanding may include

- whether that specialist's field has areas of specialty within it that are relevant to the audit.
- whether any professional or other standards and regulatory or legal requirements apply.
- what assumptions and methods are used by the management's specialist and whether they are generally accepted within that specialist's field and appropriate for financial reporting purposes.
- the nature of internal and external data or information the management's specialist uses.

.53 In the case of a management's specialist engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that specialist. Evaluating that agreement when obtaining an understanding of the work of the management's specialist may assist the auditor in determining for the auditor's purposes the appropriateness of

- the nature, scope, and objectives of that specialist's work;
- the respective roles and responsibilities of management and that specialist; and
- the nature, timing, and extent of communication between management and that specialist, including the form of any report to be provided by that specialist.

.54 In the case of a management's specialist employed by the entity, it is less likely that there will be a writ-ten agreement of this kind. Inquiry of the specialist and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding.

Evaluating the Appropriateness of the Work of the Management's Specialist

.55 Considerations when evaluating the appropriateness of the work of the management's specialist as audit evidence for the relevant assertion may include

- the relevance and reasonableness of that specialist's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- if that specialist's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- if that specialist's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

.56 When using information produced by the entity, the auditor should evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary, in the following circumstances:

a. Obtaining audit evidence about the accuracy and completeness of the information

b. Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes

.57 In order for the auditor to obtain reliable audit evidence, information produced by the entity, including any management's specialist, that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of an audit procedure, such as applying standard prices to records of sales volume to develop an expectation of sales revenue, is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorization), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

.58 Obtaining audit evidence about the accuracy and completeness of such information may be accomplished concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

.59 In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to use the entity's performance measures for the purpose of analytical procedures or use the entity's information produced for monitoring activities such as internal auditor's reports. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.

Inconsistency in, or Doubts Over Reliability of, Audit Evidence

.60 If (*a*) audit evidence obtained from one source is inconsistent with that obtained from another or (*b*) the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should determine what modifications or additions to audit procedures are necessary to resolve the matter and should consider the effect of the matter, if any, on other aspects of the audit.

.61 Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal audit, and others are inconsistent or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. AU-C section 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant finding or issue.

Linking the Assessed Risks to the Design of Further Audit Procedures

.62 As discussed in section 3130, "Assessing the Risks of Material Misstatement," the auditor's risk assessment process culminates with the articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur and—even more specifically—how the misstatements may occur and the assertions that are likely to be misstated. This assessment of the risks of misstatement, which relates identified financial reporting risks to what can go wrong at the assertion level, provides a basis for the design of further audit procedures.

Overall Responses to Risks at the Financial Statement Level

.63 The auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.

.64 The auditor's audit response to financial statement level risks should be responsive to the assessed risk. The same is true for responses to risk at the account or assertion level. It is critical that the auditor's further audit procedures are linked clearly and responsively to the assessment. Similarly, the auditor's risk assessment at the financial statement level should be clearly aligned to his or her overall audit strategy. Both the auditor's risk assessment and response should be documented. The following paragraph describes some important characteristics of financial statement level risks. The purpose of these descriptions is to help the auditor bridge between the assessment of financial statement level risks and the subsequent response.

.65 Characteristics of financial statement level risks that are relevant for audit purposes include the following:

- *Financial statement level risks can affect many assertions*. By definition, financial statement level risks may result in material misstatements of several accounts or assertions. For example, a lack of controls over journal entries increases the risk that an inappropriate journal entry could be posted to the general ledger as part of the period-end financial reporting process. The posting of an inappropriate journal entry may not be isolated to one general ledger account but potentially could affect any account. In general, overall audit risk increases when the magnitude or scope of an identified risk of misstatement is not known.
- *Assessing financial statement-level risks requires significant judgment*. Ultimately, the auditor should relate identified risks of misstatement to what can go wrong. For example, suppose that while performing risk assessment procedures to gather information about the control environment, the auditor discovered weaknesses relating to the hiring, training, and supervision of entity personnel. These weaknesses result in an increased risk of a misstatement of the financial statements, but it will be a matter of the auditor's professional judgment to determine the following:
  - — The accounts and relevant assertions that could be affected.
  - — The likelihood that a financial statement misstatement will result from the increased risks.
  - — The significance of any misstatement.
- *Risks at the Financial Statement Level May Not be Identifiable With Specific Assertions*. Control weaknesses at the financial statement level can render well-designed activity-level controls ineffective. For example, a significant risk of management override can potentially negate existing controls and procedures at the activity level in many accounts and for many assertions. Linking such a risk to specific accounts and assertions may be very difficult and may not even be possible. As another example, a client may have excellent data input controls at the application level. But if poorly designed IT general controls allow many unauthorized personnel the opportunity to access and inappropriately change the data, the well-designed input controls have been rendered ineffective. Also, strengths in financial statement-level controls such as an overall culture of ethical behavior may increase the reliability of controls that operate at the activity level. Determining the extent to which financial statement level controls affect the reliability of specific activity level controls (and, therefore, the assessment of the risks of material misstatement) is subjective and may vary from client to client.

.66 Due to the unique characteristics of financial statement level risks, it may not be possible to correlate all of these risks to a finite set of assertions. For example, a weakness in control environment may affect all or mostly all of the accounts, classes of transactions, or disclosures and the relevant assertions. To respond appropriately to these types of financial statement level risks, the auditor may need to reconsider the overall approach to the engagement. The following paragraph provides examples of overall responses to risks at the financial statement level that have a pervasive effect on the financial statements and cannot necessarily be mapped to individual assertions.

.67 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include the following:

- Emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence.

- Assigning more experienced staff or those with specialized skills or using specialists.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed and in selecting individual items for testing.
- Making general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date. One could also focus more time and attention on audit areas more closely associated with the risks.

.68 The assessment of the risks of material misstatement at the financial statement level and, thereby, the auditor's overall responses are affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and, thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period-end. Deficiencies in the control environment, however, have the opposite effect (for example, the auditor may respond to an ineffective control environment by

- conducting more audit procedures as of the period-end rather than at an interim date,
- obtaining more extensive audit evidence from substantive procedures, and
- increasing the number of locations to be included in the audit scope).

.69 Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach) or an approach that uses tests of controls as well as substantive procedures (combined approach).

.70 Paragraphs .A9–.A10 and .A38–.A42 of AU-C section 240 describe the overall responses the auditor may take in response to his or her assessment of the risk of material misstatement due to fraud. When determining an overall audit response, the auditor may consider the assessment of fraud risk concurrently with the assessment of the risks of material misstatement due to error. The auditor can develop one overall response that is appropriate for both kinds of risks.

Audit Procedures Responsive to Risks of Material Misstatement at the Relevant Assertion Level

The Nature, Timing, and Extent of Further Audit Procedures

.71 Further audit procedures provide important audit evidence to support the auditor's audit opinion. These procedures consist of tests of controls and substantive procedures.

.72 The auditor should design and perform further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level. Designing and performing further audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

.73 The auditor's assessment of the identified risks at the relevant assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that

a. in addition to the substantive procedures that are required for all relevant assertions, in accordance with paragraph .18 of AU-C section 330, an effective response to the assessed risk of material misstatement for a particular assertion can be achieved only by also performing tests of controls.

b. performing only substantive procedures is appropriate for particular assertions, and therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because testing controls would be inefficient, and therefore, the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures.

c. a combined approach using both tests of controls and substantive procedures is an effective approach.

Responding to the Assessed Risks at the Assertion Level

.74 In designing the further audit procedures to be performed, the auditor should

a. consider the reasons for the assessed risk of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure, including

   i. the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (the inherent risk) and

   ii. whether the risk assessment takes account of relevant controls (the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures), and

b. obtain more persuasive audit evidence the higher the auditor's assessment of risk.

.75 When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable (for example by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources).

.76 *Nature of the response*. The nature of further audit procedures refers to the following:

- Their purpose, that is, tests of controls or substantive procedures (or dual purpose tests) and whether they are designed to test for overstatement, understatement, or both
- Their type, such as the following:
  - — Inspection
  - — Observation
  - — Inquiry
  - — Confirmation
  - — Recalculation
  - — Reperformance
  - — Analytical procedures (including scanning)

Table 1 provides additional guidance on each of these procedures.

Table 1

Types of Audit Procedures

Type of Procedure	*Definition*	*Additional Guidance*
Inspection of documents	Inspection of documents involves examining records or documents, whether internal or external, in paper form, electronic form, or other media.	• This procedure provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal documents, on the effectiveness of the controls over their production. • Some documents represent direct audit evidence of the existence of an asset but not necessarily about ownership or value. • Inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting principles, such as revenue recognition. • Some forms of documents are less persuasive than others. For example, faxes and copies may be less reliable than original documents.
Inspection of tangible assets	Inspection of tangible assets consists of physical examination of the assets.	• This procedure may provide audit evidence relating to existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. • Inspection of individual inventory items ordinarily accompanies the observation of inventory counting.
Observation	Observation consists of looking at a process or procedure being performed by others.	• This procedure provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed.
Confirmation	Confirmation is the process of obtaining a representation of information or of an existing condition directly from a knowledgeable third party.	• This procedure — frequently is used in relation to account balances and their components but need not be restricted to these items; — can be designed to ask if any modifications have been made to an agreement, and if so, what the relevant details are; and

Type of Procedure	*Definition*	*Additional Guidance*
		— also is used to obtain audit evidence about the absence of certain conditions (for example, the absence of an undisclosed agreement that may influence revenue recognition). • See AU-C section 505 for further guidance on confirmations.
Recalculation	Recalculation consists of checking the mathematical accuracy of documents or records.	• This procedure can be performed through the use of information technology, for example, by applying a data extraction application or other computer assisted audit techniques (CAATs).
Reperformance	Reperformance is the auditors independent execution of procedures or controls that were originally performed as part of the entity's internal control	• This procedure may be performed either manually or through the use of CAATs, for example, reperforming the aging of accounts receivable.

.77 The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, regarding revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

.78 The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph .08*a* of AU-C section 330. This may be the case, for example, for a class of transactions of reasonably uniform, noncomplex characteristics that are routinely processed and controlled by the entity's information system.

.79 The nature of further audit procedures is of most importance in responding to the assessed risks.

.80 *Timing of the response.* Timing refers to when further audit procedures are performed or the period or date to which the audit evidence applies. The auditor may perform tests of controls or substantive procedures

- at an interim date.
- at period end.
- after period end, in those instances where the procedure cannot be performed prior to or at year end (for example, agreeing the financial statements to the accounting records).

.81 The auditor may perform tests of controls or substantive procedures at an interim date or at the period-end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to or at the period-end rather than at an earlier date or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from the interim date to the period-end would not be effective.

.82 On the other hand, performing audit procedures before the period-end may assist the auditor in identifying significant issues at an early stage of the audit and consequently resolving them with the assistance of management or developing an effective audit approach to address such issues.

.83 In addition, certain audit procedures can be performed only at or after the period-end. For example

- agreeing the financial statements to the accounting records,
- examining adjustments made during the course of preparing the financial statements, and
- procedures to respond to a risk that at the period-end the entity may have entered into improper sales contracts or transactions may not have been finalized.

.84 Further relevant factors that influence the auditor's consideration of when to perform audit procedures include

- the effectiveness of the control environment.
- when relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- the nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may examine contracts available on the date of the period-end).
- the period or date to which the audit evidence relates.

.85 *Extent of the response*. Extent refers to the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure may be determined by the judgment of the auditor after considering all of the following:

- Performance materiality
- Assessed risks of material misstatement
- Degree of assurance the auditor plans to obtain

.86 In particular, the auditor may increase the extent of audit procedures as the risks of material misstatement increase. However, increasing the extent of audit procedures is effective only if the audit procedures themselves are both relevant to the specific risks and reliable; therefore, the nature of the audit procedure is the most important consideration.

.87 The extent of an audit procedure judged necessary is determined after considering the materiality, assessed risk, and degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure may be considered separately. In general, the extent of audit procedures increases as the risks of material misstatement increase. For example, in response to the assessed risks of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

.88 The use of computer assisted audit techniques may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing (for example, in responding to the risks of material misstatement due to fraud). Such techniques can be used to select sample transactions from key electronic files, sort transactions with specific characteristics, or test an entire population instead of a sample.

.89 *Considerations specific to smaller, less complex entities*. In the case of smaller entities, the auditor may not identify control activities, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control activities or other components of control may make it impossible to obtain sufficient appropriate audit evidence.

.90 The AICPA Audit Guide *Audit Sampling* provides additional guidance on sampling for substantive testing. Also, section 5400, "Audit Sampling Considerations," provides discussion on the use of sampling during an audit.

Adequacy of Presentation and Disclosure

.91 The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. Evaluating the overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information and the form, arrangement, and content of the financial statements, including the related notes. This includes, for example, the terminology used, the amount of detail given, the classification of items in the financial statements, and the basis of amounts set forth.

Evaluating the Sufficiency and Appropriateness of Audit Evidence

.92 Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate, before the conclusion of the audit, whether the assessments of the risks of material misstatement at the relevant assertion level remain appropriate.

.93 An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessments were based. For example

- the extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's professional judgment about the risk assessments and indicate a significant deficiency or material weakness in internal control.
- the auditor may become aware of discrepancies in accounting records or conflicting or missing evidence.
- analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. AU-C section 315 contains further guidance on revising the auditor's risk assessment.

.94 The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

.95 The auditor should conclude whether sufficient appropriate audit evidence has been obtained. In forming a conclusion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements.

.96 The auditor's professional judgment about what constitutes sufficient appropriate audit evidence is influenced by such factors as the

- significance of the potential misstatement in the relevant assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements (see AU-C section 450).
- effectiveness of management's responses and controls to address the risks.
- experience gained during previous audits with respect to similar potential misstatements.
- results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- source and reliability of the available information.
- persuasiveness of the audit evidence.
- understanding of the entity and its environment, including its internal control.

.97 If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or disclaim an opinion on the financial statements.

Documentation

.98 The auditor should include in the audit documentation

a. the overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures performed;

b. the linkage of those procedures with the assessed risks at the relevant assertion level; and

c. the results of the audit procedures, including the conclusions when such conclusions are not otherwise clear.

.99 If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor should include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.

.100 The auditor should include in the audit documentation the basis for any determination not to use external confirmation procedures for accounts receivable when the account balance is material.

.101 The auditor's documentation should demonstrate that the financial statements agree or reconcile with the underlying accounting records.

.102 The form and extent of audit documentation is a matter of professional judgment and is influenced by the nature, size, and complexity of the entity; internal control of the entity; availability of information from the entity; and the audit methodology and technology used in the audit.

.103 AU-C section 230 establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

[*The next page is 5201.*]

AAM Section 5200

Performing Tests of Controls

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 230, *Audit Documentation*
- AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*
- AU-C section 500, *Audit Evidence*
- AU-C section 520, *Analytical Procedures*
- AU-C section 530, *Audit Sampling*

General Considerations When Testing Controls

Obtaining Sufficient Appropriate Audit Evidence About the Operating Effectiveness of Relevant Controls

.01 The auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant controls if

- the auditor's assessment of risks of material misstatement at the relevant assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of substantive procedures) or
- substantive procedures alone cannot provide sufficient appropriate audit evidence at the relevant assertion level.

.02 Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in a relevant assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

.03 Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time the auditor is evaluating their design and determining that they have been implemented.

.04 The auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, which also is known as a *dual purpose test*. A dual purpose test is designed and evaluated by considering each purpose of the test separately. Additional discussion on dual purpose tests follows in this section.

.05 In some cases, the auditor may find it impossible to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence at the relevant assertion level. This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph .08*b* of AU-C section 330 requires the auditor to perform tests of relevant controls.

.06 The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. See AU-C section 520 for further guidance.

Sources of Audit Evidence About Internal Control Effectiveness

.07 The audit evidence used to provide support for the auditor's conclusion about the operating effectiveness of controls during the audit period may come from a variety of sources, including the following:

- Tests of controls performed during the current period.
- Risk assessment procedures performed during the current period.
- Evidence provided in a type 2 SOC 1℠ report under AU-C section 402.
- Evidence obtained from the performance of procedures in previous audits.
- The information gathered and conclusions reached as part of the auditor's quality control procedures for client acceptance and continuance. For example, client acceptance procedures may include inquiries of attorneys, bankers, or others in the business community about client management that provide insight into their
  - competence,
  - integrity,
  - operating philosophy, and
  - ethical values.

.08 AU-C section 500 establishes requirements and provides guidance regarding audit evidence in an audit of financial statements. Section 5100, "Audit Evidence and Designing Further Audit Procedures," provides additional discussion on audit evidence and AU-C section 500.

Risk Assessment Procedures Versus Tests of Controls

.09 Risk assessment procedures allow the auditor to evaluate the design effectiveness of internal control for the purpose of assessing risks of material misstatement. Tests of controls build on the auditor's evaluation of design effectiveness and allow the auditor to assess the operating effectiveness of controls during the operating period. The results of the auditor's tests of controls are used to design substantive procedures.

.10 Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included the following:

- Inquiring about management's use of budgets
- Observing management's comparison of monthly budgeted and actual expenses
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented but also may provide audit evidence about the effectiveness of the operation of budgeting policies in preventing, or detecting and correcting, material misstatements in the classification of expenses.

Evidence of Operating Effectiveness of Controls at a Service Organization

.11 A SOC 1 type 2 service auditor's report may provide evidence about the operating effectiveness of controls at a service organization. However, controls over the information provided to the service organization may still need to be assessed. Chapter 6, "Performing Further Audit Procedures," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* provides additional guidance on evaluating the operating effectiveness of controls at a service organization.

Evaluating the Effectiveness of Indirect Controls

.12 The auditor should determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those indirect controls.

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

Tests of IT Controls

.14 In some circumstances, in addition to testing the controls that relate directly to assertions, it may be necessary for the auditor to obtain audit evidence supporting the effective operation of indirect controls upon which the effectiveness of the direct control depends. For example, assume the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits. The user review combined with the related follow up is the control that is of direct relevance to the auditor. The controls over the accuracy of the information in the reports (for example, the general IT controls) are described as indirect controls.

.15 Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general IT controls (in particular, change controls), also may provide substantial audit evidence about its operating effectiveness. That is, once the auditor has determined that an IT application control has been implemented (placed in operation), the auditor may draw a conclusion about the operating effectiveness of the IT portion of the control activity, so long as the auditor has determined that relevant IT general controls are operating effectively.

.16 When considering the need to test indirect controls, the auditor may consider the following:

- *The significance of the indirect control to the effective functioning of the direct control.* As the effectiveness of the direct control becomes more dependent on the indirect control, the auditor's need to test the indirect control generally increases.
- *The relative significance of the audit evidence of the indirect control to the auditor's conclusion on the effectiveness of the direct control.* The auditor's conclusion about the operating effectiveness of a control activity is supported by a combination of evidence about (*a*) the operating effectiveness of the direct control activity itself and (*b*) the operating effectiveness of other, indirect controls upon which the effectiveness of the direct control depends. In some instances, the auditor may be able to support a conclusion based primarily on tests of the direct control, with little evidence about the operating effectiveness of the related indirect controls. In other instances (for example, IT application controls), the auditor's conclusion may be based primarily on tests of the indirect controls and little on tests of the direct control. In those situations where you rely significantly on the operating effectiveness of the indirect control, the auditor should obtain more sufficient and adequate audit evidence to support the conclusion on the operating effectiveness of the indirect control, for example, the monitoring of the performance of the reconciliation.

- *The degree of reliability required of the audit evidence obtained about internal control operating effectiveness.* Testing the indirect control increases the reliability of the audit evidence obtained about the operating effectiveness of the direct control. For example, the auditor may test 4 month-end reconciliations and draw a conclusion about the effectiveness of those reconciliations for an entire 12-month period. If the auditor has tested the operating effectiveness of the indirect controls related to the reconciliation, the conclusion about the effectiveness of the reconciliation during the period the auditor did not test will be more reliable than if the auditor did not test the indirect controls.
- *Evidence of operating effectiveness that may have been obtained as part of obtaining an understanding of the design and implementation of the indirect controls.* When performing risk assessment procedures to obtain an understanding of internal control, the auditor may obtain some information about the operating effectiveness of the indirect controls as they relate to an assertion. For example, risk assessment procedures may provide the auditor with some evidence about the operating effectiveness of portions of the control environment. This information about operating effectiveness may be limited, but nevertheless, it may be sufficient for the purpose of drawing a conclusion about the operating effectiveness of the direct control.

.17 When testing indirect controls, the auditor may choose not to test the operating effectiveness of the entire component to which the indirect control pertains, but may limit the tests to those elements of the component that have an immediate bearing on the effectiveness of the direct control. For example, when testing controls over purchasing to place moderate reliance on them, the auditor may consider the need to test the control environment or IT general controls relating to the entire entity beyond the design and implementation assessment procedures the auditor already has performed. If practical, the auditor may limit the tests to those aspects of the control environment or IT general controls that have a direct bearing on the financial statement assertions related to purchasing. To place high reliance on the controls, the auditor may often need to gather additional evidence concerning the IT general controls and overall control environment to support high reliance on the purchasing controls.

The Relationship Between Tests of Controls and Substantive Procedures

.18 Generally, there is an inverse relationship between the persuasiveness of the audit evidence to be obtained from substantive procedures and that obtained from tests of controls. As the persuasiveness of the audit evidence obtained from tests of controls increases, the persuasiveness of the audit evidence required from substantive procedures likely decreases. For example, in circumstances when the auditor adopts a strategy at the assertion level that consists primarily of tests of controls, a higher level of assurance may be sought about the operating effectiveness of controls, in particular when it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

.19 On the other hand, the more audit evidence that can be obtained from substantive procedures, the less audit evidence would be necessary from tests of controls. In many instances, the nature and extent of substantive procedures alone may provide sufficient, appropriate evidence at the assertion level, which would make the testing of control effectiveness (beyond assessing their design and implementation) unnecessary. The risk model discussion in the AICPA Audit Guide *Audit Sampling* provides a framework for assessing how controls testing can influence other substantive procedures.

A Financial Statement Audit Versus An Examination of Internal Control

.20 Testing the operating effectiveness of internal control to support an opinion on the financial statements is different from testing controls to support an opinion on the effectiveness of the internal control system.

.21 In an attestation engagement to examine the effectiveness of internal control, the audit evidence obtained from the tests of internal control is the only evidence the auditor has to support an opinion. In contrast, when performing an audit of the financial statements, the auditor ordinarily performs both tests of controls and substantive procedures. The objective of the tests of controls in a financial statement audit is to assess the operating effectiveness of controls and incorporate this assessment into the design of the nature, timing, and extent of substantive procedures. Thus, when testing controls in a financial statement audit, the auditor has flexibility in determining not only whether to test controls, and if so which controls to test, but also the level of effectiveness of those controls that is necessary to provide the desired level of support for an opinion on the financial statements.

Determining the Nature of the Tests of Controls

.22 The nature of the procedures the auditor performs to test controls has a direct bearing on the relevance and reliability of audit evidence. When responding to assessed risks of material misstatement, the nature of the audit procedures is of most importance. Performing more tests or conducting the tests closer to the period end will not compensate for a poorly designed test that produces information that lacks relevance or reliability about the effectiveness of a control.

.23 In designing and performing tests of controls, the auditor should perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including

a. how the controls were applied at relevant times during the period under audit;

b. the consistency with which they were applied; and

c. by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

.24 The types of audit procedures available for obtaining audit evidence about the effectiveness of controls can include the following:

- Inquiries of appropriate entity personnel
- Inspection of documents, reports, or electronic files indicating performance of the control
- Observation of the application of the control
- Reperformance of the application of the control by the auditor

.25 The nature of the particular control influences the type of audit procedure necessary to obtain audit evidence about operating effectiveness. Documentation may provide evidence about the performance of some controls; in these situations, the auditor may inspect this documentation to obtain evidence about the operating effectiveness of the control.

.26 For other controls, documentation may not be available or relevant. For example, documentation of the operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed automatically by the client's IT system. In these circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation of the performance of the control or the use of computer assisted audit techniques. Under AU-C section 265, entities should be encouraged to improve weak documentation.

.27 Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection, recalculation, or reperformance may provide more assurance than inquiry and observation because an observation is pertinent only at the point in time at which it is made.

.28 Because of the limits of inquiry and observation, inquiry combined with inspection or reperformance ordinarily provide more relevant and reliable audit evidence than a combination of only inquiry and observation. For example, the auditor may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor might find it necessary to supplement the observation with other observations or inquiries of entity personnel, and the auditor may also inspect documentation about the operation of such controls at other times during the audit period.

.29 *Considerations specific to smaller, less complex entities*. In some situations an entity might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for an entity's financial reporting and associated controls, the auditor may take into account the combined competence of entity personnel and other parties that assist with functions related to financial reporting.

Tests of Spreadsheets

.30 The development and use of spreadsheets typically lack the controls that usually are present for formal, purchased software. Absent audit evidence indicating that appropriate general controls over spreadsheets have been implemented, the auditor may continue to test spreadsheet controls even after their implementation.

Dual Purpose Tests

.31 Some audit procedures may simultaneously provide audit evidence that both

- support the relevant assertion or detects material misstatement and
- support a conclusion about the operating effectiveness of related controls.

Tests that achieve both of these objectives concurrently on the same transaction typically are referred to as dual purpose tests. For example, the auditor may design and evaluate the results of a test to examine an invoice to determine whether it has been approved and also to provide substantive audit evidence of the transaction.

.32 When performing a dual purpose test, the auditor may consider whether the design and evaluation of such tests can accomplish both objectives. For example, to meet both objectives the population of controls and the population of substantive procedures would have to be the same. If tests on components of a balance such as receivables are designed as dual purpose tests, only evidence of the controls operating over period-end balance items will be obtained.

.33 Furthermore, when performing such tests, the auditor may consider how the outcome of the tests of controls affect the auditor's determination about the extent of substantive procedures to be performed. For example, if controls are found to be ineffective, the auditor would consider whether the sample size that was designed for the dual purpose test was adequate or whether the sample size for substantive procedures should be increased from that originally planned.

.34 Additional guidance on the use of dual purpose tests is found in chapter 2 of the AICPA Audit Guide *Audit Sampling*.

Determining the Timing of Tests of Controls

.35 The timing of tests of controls affects the relevance and reliability of the resulting audit evidence. In general, the relevance and reliability of the audit evidence obtained diminishes as time passes between the testing of the controls and the end of the period under audit. For this reason, when tests of controls are performed during an interim period or carried forward from a previous audit, the auditor should determine what additional audit evidence should be obtained to support a conclusion on the current operating effectiveness of those controls.

.36 The auditor should test controls for the particular time or throughout the period for which the auditor intends to rely on those controls in order to provide an appropriate basis for the auditor's intended reliance. The timing of tests of controls depends on the auditor's objective:

- When controls are tested as of a point in time, the auditor may obtain audit evidence that the controls operated effectively only at that time.

- When controls are tested throughout a period, the auditor may obtain audit evidence of the effectiveness of the operation of the control during that period.

.37 Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the client's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, test that are capable of providing audit evidence that the control operated effectively at relevant times during the period under audit are appropriate. For example, for an automated control, the auditor may test the operation of the control at a particular point in time. The auditor then may perform tests of controls to determine whether the control operated consistently during the audit period, or the auditor may test with the intention of relying on general controls pertaining to the modification and use of that computer program during the audit period.

.38 The tests the auditor performs to supplement tests of controls at a point of time may be part of the tests of controls over the client's monitoring of controls.

Updating Tests of Controls Performed During an Interim Period

.39 The auditor may test controls as of or for a period that ends prior to the balance sheet date. This date often is referred to as the *interim date* or *interim period*. The period of time between the interim date or period and the balance sheet date often is referred to as the *remaining period*.

.40 When the auditor tests controls during an interim period or as of an interim date, the auditor should

- obtain audit evidence about the nature and extent of any significant changes in internal control that occurred subsequent to the interim period or interim date and
- determine what additional audit evidence should be obtained for the remaining period.

.41 Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after the interim period or interim date, include the following:

- The significance of the assessed risks of material misstatement at the relevant assertion level
- The specific controls that were tested during the interim period
- The degree to which audit evidence about the operating effectiveness of those controls was obtained
- The length of the remaining period
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls
- The effectiveness control environment
- The volume or value of transactions processed in the remaining period

.42 The auditor may obtain additional audit evidence about the operating effectiveness of controls during the remaining period by performing procedures such as

- extending the testing of the operating effectiveness of controls over the remaining period or
- testing the client's monitoring of controls.

.43 Procedures the auditor may perform during the remaining period include:

- inquiries and observations related to the performance of the control, the monitoring of the control, or any changes to the control during the remaining period;
- a walkthrough covering the period between the interim date and the period end; and
- the same procedures performed at interim, but directed to the period from interim to period end.

Use of Audit Evidence Obtained in Prior Audits

.44 In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits and, if so, the length of the time period that may elapse before retesting a control, the auditor should consider

- the effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
- the risks arising from the characteristics of the control, including whether the control is manual or automated;
- the effectiveness of general IT controls;
- the effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits and whether there have been personnel changes that significantly affect the application of the control;
- whether the lack of a change in a particular control poses a risk due to changing circumstances; and
- the risks of material misstatement and the extent of reliance on the control.

.45 In certain circumstances, audit evidence obtained from previous audits may provide audit evidence, provided that the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

.46 The following table summarizes the factors the auditor should consider when determining whether to use audit evidence about the operating effectiveness obtained in a prior audit.

	Appropriateness of Using Evidence From Prior Audit		*Length of Time Before Retesting Control*	
	May be appropriate	*May not be appropriate*	*Longer*	*Shorter*
Effectiveness of control environment, the client's risk assessment, monitoring, and IT general controls	Effective design and operation	Evidence of poor design or operation	Effective design and operation	Evidence of poor design or operation
Risks arising from characteristics of the control	Largely automated control	Significant manual or judgmental component to control	Largely automated control	Significant manual or judgmental component to control

	Appropriateness of Using Evidence From Prior Audit		*Length of Time Before Retesting Control*	
	May be appropriate	*May not be appropriate*	*Longer*	*Shorter*
Changes in circumstances at the client that may require changes in controls, including personnel changes that affect application of the control	Minor changes in client circumstances, including personnel	Significant changes in client circumstances, including personnel	Minor changes in client circumstances, including personnel	Significant changes in client circumstances, including personnel
Operating effectiveness of the control	Control operated effectively in prior audit	Control did not operate effectively in prior audit	Control operated effectively in prior audit	Control did not operate effectively in prior audit
Risks of material misstatement	Low risk of material misstatement for relevant assertion	High risk of material misstatement for relevant assertion	Low risk of material misstatement for relevant assertion	High risk of material misstatement for relevant assertion
Extent of reliance on the control to design substantive procedures	Low reliance on the control	High reliance on the control	Low reliance on the control	High reliance on the control

.47 If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor should perform audit procedures to establish the continuing relevance of that information to the current audit. The auditor should obtain this evidence by performing inquiry, combined with observation or inspection, to confirm the understanding of those specific controls, and

- if there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor should test the controls in the current audit.
- if there have not been such changes, the auditor should test the controls at least once in every third audit and should test some controls during each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods.

.48 The procedures performed as described in the preceding paragraph may help the auditor fulfill his or her responsibility described in the previous paragraph; however, the auditor may have to supplement these procedures with others. For example, if the controls have not changed from the previous period but the client's business process has, the auditor will need to determine whether the design of controls remains effective in light of the changed business processes.

.49 The auditor may not rely on audit evidence about the operating effectiveness of controls obtained in prior audits for controls that

- have changed significantly since the prior audit,
- pertain to business processes that have changed significantly since the prior audit, and
- mitigate significant risks.

For any control that meets one of the preceding criteria, the auditor should test operating effectiveness in the current audit.

Controls That Have Changed From the Previous Audit

.50 Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably is not a significant change and, therefore, is unlikely to affect the relevance of prior period audit evidence. On the other hand, a change that causes data to be accumulated or calculated differently probably is significant and, therefore, does affect the relevance of audit evidence obtained in the prior period, in which case the operating effectiveness of the control should be tested in the current period.

Controls That Have Not Changed From the Previous Audit

.51 The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that

- have not changed since they were last tested and
- are not controls that mitigate a significant risk

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment but is required by paragraph .14*b* of AU-C section 330 to be at least once in every third audit. (***Note***: This guidance may not be appropriate for audits not performed at least on an annual basis.)

Rotating Emphasis on Tests of Controls

.52 When the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of these controls at least once in every third year in an annual audit. There also may be some controls, such as over revenue recognition or inventories that, due to their importance to the client financial statements, might be subject to testing every two years or every year, depending on the risks, even when there are purported to be no changes in controls.

.53 In general, the higher the risk of material misstatement or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control or result in not relying on audit evidence obtained in previous audits at all include the following:

- A deficient control environment
- Deficient monitoring of controls
- A significant manual element to the relevant controls
- Personnel changes that significantly affect the application of the control
- Changing circumstances that indicate the need for changes in the control
- Deficient general IT controls

.54 When there are a number of controls for which the auditor plans to use audit evidence obtained in prior audits, the auditor may wish to test the operating effectiveness of some controls each audit. However, when the auditor is testing controls for only one or two key classes of transactions in an entity, rotating the testing of these controls may not be warranted.

Controls Over Significant Risks

.55 If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor should test the operating effectiveness of those controls in the current period.

Determining the Extent of Tests of Controls

.56 The extent of the auditor's tests of controls affects the sufficiency of the audit evidence obtained to support the auditor's assessment of the operating effectiveness of controls. In designing and performing tests of controls, the auditor should obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. As such, the auditor may increase the extent of testing the controls to obtain the desired level of assurance that the controls are operating effectively

- at the relevant assertion level and
- either throughout the period, or as of the point in time when the auditor plans to rely on the control.

.57 Factors the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects, material misstatements at the relevant assertion level.
- The extent to which audit evidence is obtained from tests of other controls that meet the same audit objective.
- The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control). The more the auditor relies on the operating effectiveness of controls in the assessment of risk, the greater is the extent of the auditor's tests of controls.
- The expected deviation from the control.

.58 The rate of expected deviation may indicate that obtaining audit evidence from the performance of tests of controls will not be sufficient to reduce the control risk at the relevant assertion level. If the rate of expected deviation is expected to be high, tests of controls for a particular assertion may not provide sufficient appropriate audit evidence. AU-C section 530 contains further guidance on the extent of testing. AU-C section 530 is also discussed in section 5400, "Audit Sampling Considerations."

Tests of IT Controls

.59 Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that

- changes to the program are not made without being subject to the appropriate program change controls,
- the authorized version of the program is used for processing transactions, and
- other relevant general controls are effective.

Such tests also might include determining that changes to the programs have not been made, which may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

Sampling Considerations

.60 The auditor may consider using an audit sampling technique to determine the extent of tests whenever the control is applied on a transaction basis (for example, matching approved purchase orders to supplier invoices) and that it is applied frequently. When a control is applied periodically (for example, monthly reconciliations of accounts receivable subsidiary ledger to the general ledger), the auditor might consider guidance appropriate for testing smaller populations (for example, testing the control application for two months and reviewing evidence the control operated in other months or reviewing other months for unusual items). AU-C section 530 and the AICPA Audit Guide *Audit Sampling* provide further guidance on the application of sampling techniques to determine the extent of testing of controls. The AICPA Audit Guide *Audit Sampling* also provides guidance for testing in smaller populations. Additional discussion on audit sampling is also included in section 5400, "Audit Sampling Considerations."

.61 As indicated in paragraph .A31 of AU-C section 330 (discussed in paragraph .57), the auditor may consider the expected deviation from the control when determining the extent of tests. As the rate of expected deviation from a control increases, the auditor may increase the extent of testing of the control. However, if the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may not be effective. In this case, the auditor may conclude that a deficiency in internal control exists and the auditor should consider its severity and whether it should be communicated to those charged with governance, management, or both. A control deficiency exists when the observed rate of deviation exceeds the expected rate of deviation used in designing the controls test.

Assessing the Operating Effectiveness of Controls

.62 When evaluating the operating effectiveness of relevant controls, the auditor should evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the relevant assertion being tested are effective.

.63 In accordance with AU-C section 265, the identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity's internal control is an indicator of a material weakness.

Evidence About Operating Effectiveness

.64 The concept of effectiveness of the operation of controls recognizes that some deviations in the way a client applies the controls may occur. Deviations from prescribed controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error.

.65 When the auditor encounters deviations in the operation of controls, those deviations will have an effect on the auditor's assessment of operating effectiveness. A control with an observed nonnegligible deviation rate is not an effective control. For example, if a test is designed in which the auditor selects a sample of, say, 25 items and expects no deviations, the finding of 1 deviation would be considered a nonnegligible deviation because, based on the results of the test of the sample, the desired level of confidence has not been obtained.

.66 There are sources of audit evidence beyond the auditor's tests of controls that contribute to the auditor's assessment of the operating effectiveness of controls. The extent of misstatements detected by performing substantive procedures also may alter the auditor's judgment about the effectiveness of controls in a negative direction. However, misstatement-free results of substantive procedures do not indicate that a lower assessment of control risk may be substituted for the one supported by the procedures the auditor used to assess control risk.

Investigating Additional Implications of Identified Deviations

.67 When the auditor detects control deviations during the performance of tests of controls, the auditor should make specific inquiries to understand these matters and their potential consequences (for example, inquiring about the timing of personnel changes in key internal control functions) and should determine whether

a. the tests of controls that have been performed provide an appropriate basis for reliance on the controls,

b. additional tests of controls are necessary, or

c. the potential risks of misstatement need to be addressed using substantive procedures.

.68 The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations in the application of control activities may be caused by the ineffective operation of indirect controls such as IT general controls, the control environment, or other components of internal control (for example, changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error.) To gain an understanding of the deviations in control, the auditor may wish to make inquiries and perform other tests to identify possible weaknesses in the control environment or other indirect controls. The detected rate of deviation, in particular, in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the relevant assertion level to that assessed by the auditor.

.69 For example, suppose that one of the client's primary controls related to the existence of inventory—periodic test counts—had several instances where the number of items counted by the count teams did not agree to the actual physical count of the items on hand. When gaining a further understanding of the nature of these deviations, the auditor determines that the underlying cause is poor training of the test count teams and a lack of written instructions. Training and written instructions are indirect controls that may affect the operating effectiveness of controls other than those related to existence. For example, the lack of training and instruction could result in the count teams reporting the wrong product number or description, which also could affect the valuation of inventory. This finding could cause the company and auditor to conclude that a recount is necessary once the teams are properly trained.

Assessing Effectiveness

.70 After considering the results of tests of controls and any misstatements detected from the performance of substantive procedures, the auditor should determine whether the audit evidence obtained provides an appropriate basis for reliance on the controls. If the reliance on the controls is not warranted, the auditor should determine whether

- additional tests of controls are necessary or
- if the potential risks of misstatement will be addressed using substantive procedures.

Once the auditor has concluded that reliance on certain controls is not warranted, it is unnecessary to perform further tests of those controls.

Deficiencies in the Operation of Controls

.71 The auditor may consider whether deviations in the operation of controls have been caused by an underlying deficiency in internal control. When evaluating the reason for a control deviation, the auditor may consider the following:

- Whether the control is automated (in the presence of effective information technology general controls, an automated application control is expected to perform as designed)
- The degree of intervention by entity personnel contributing to the deviation (for example, was the deviation evidence of a possible override)

- Management's actions in response to the matter (if management was aware of the deviation)

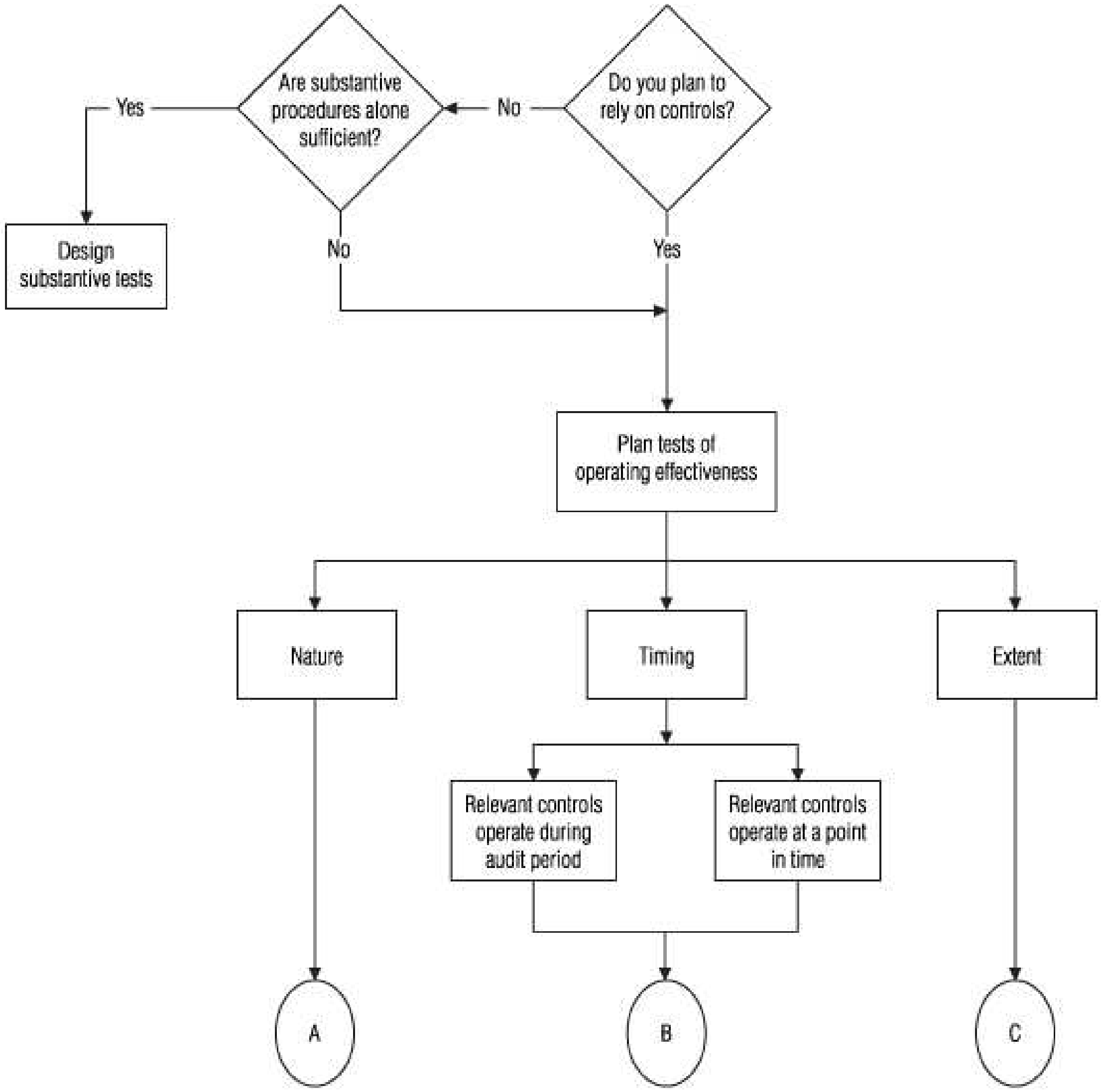
If the auditor identifies one or more deficiencies in internal control, the auditor should evaluate each deficiency to determine whether, individually or in combination, they constitute significant deficiencies or material weaknesses.

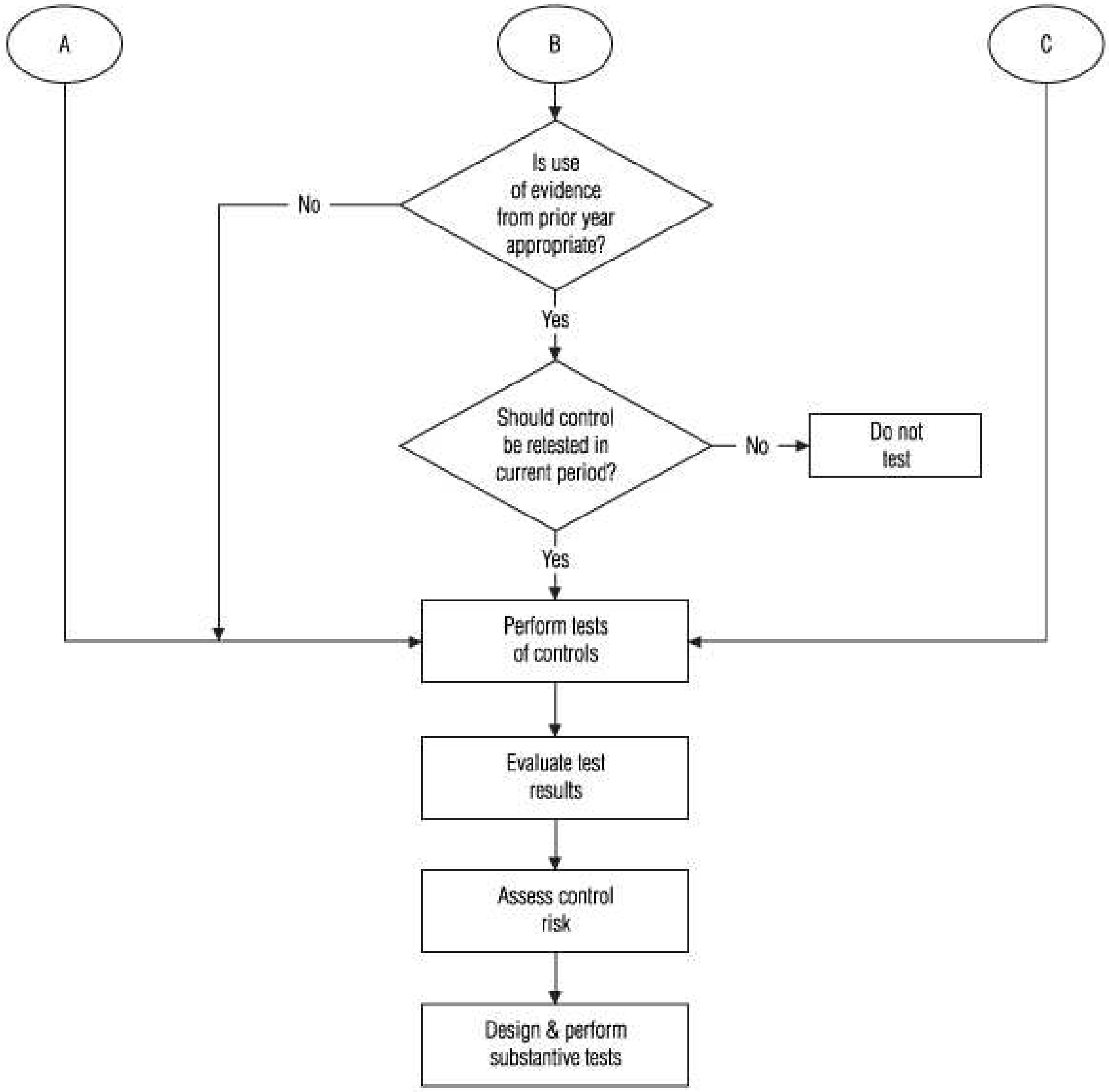
.72 Regardless of the reason for the deviation, numerous or repeated instances of the deviation may constitute a significant deficiency or material weakness.

.73 The following are examples of circumstances that may be deficiencies in internal control of some magnitude:

- Failure in the operation of properly designed controls within a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements).
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. For example, a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. However, a preventive control failure may be mitigated by an effective detective control that prevents the misstatement of the financial statements. Suppose the inventory security control fails. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely (near or at the reporting date). In the absence of a timely count, a deficient preventive control may be a deficiency in internal control of some magnitude.
- Failure to perform reconciliations of significant accounts, for example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, consistent under accruals of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls that would enable the entity to prepare financial statements in accordance with generally accepted accounting principles.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
- An observed deviation rate that exceeds the number of deviations that the auditor expected in a test of the operating effectiveness of a control. For example, if the auditor designed a test in which he or she selected a sample and expected no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

.74 The following diagram summarizes the auditor's considerations related to tests of controls:




A
B
C
Is use of evidence from prior year appropriate?
No
Yes
Should control be retested in current period?
No
Do not test
Yes
Perform tests of controls
Evaluate test results
Assess control risk
Design & perform substantive tests

Adequacy of Presentation and Disclosure

.75 Section 5100, "Audit Evidence and Designing Further Audit Procedures," provides additional discussion regarding the auditor's evaluation of the overall presentation of the financial statements, including the related disclosures.

Evaluating the Sufficiency and Appropriateness of Audit Evidence

.76 Section 5100 provides additional discussion regarding the auditor's evaluation of the sufficiency and appropriateness of audit evidence obtained.

Documentation

.77 Section 5100 provides additional discussion regarding audit documentation requirements. AU-C section 230 establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

[*The next page is 5301.*]

AAM Section 5300

Performing Substantive Procedures

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 520, *Analytical Procedures*
- AU-C section 530, *Audit Sampling*

.01 The objective of substantive procedures is to detect individual misstatements that alone or in the aggregate cause material misstatements at the assertion level. Substantive procedures include the following:

- Tests of details of transactions, account balances, and disclosures.
- Analytical procedures. AU-C section 520 establishes standards and provides guidance on the application of analytical procedures as substantive procedures.

.02 The auditor should design and perform substantive procedures to be responsive to the related assessed risks of material misstatement. However, the auditor should design perform substantive procedures for all relevant assertions related to each material class of transactions, account balances, or disclosures regardless of the risk assessment because the risk assessment may not identify all risks. This requirement reflects the facts that (*a*) the auditor's assessment of risk is judgmental and may not identify all risks of material misstatement and (*b*) inherent limitations to internal control exist, including management override.

- *Substantive procedures of material items*. The auditor should perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. For example, if the auditor determines that long term debt is a material account, the auditor should perform substantive procedures for all assertions that are relevant to long term debt, even if the auditor has determined that it is unlikely that the assertion could contain a material misstatement. The auditor may determine that the risk of the entity not having the obligation to repay the debt (the obligation assertion) is low, but nevertheless, the auditor should perform a substantive procedure (for example, confirming the terms of the debt with the lender) to address the risk. Because the account is material, the auditor is precluded from relying solely on risk assessment procedures or tests of controls to support the conclusion.
- *Substantive procedures related to the financial statement closing process*. On all engagements the auditor should include audit procedures related to the financial statement closing process, such as
    - — agreeing the financial statements, including their accompanying notes, to the underlying accounting records and
    - — examining material journal entries and other adjustments made during the course of preparing the financial statements. The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the client's financial reporting system and the associated risks of material misstatement.

External Confirmation Procedures

.03 The auditor should consider whether external confirmation procedures are to be performed as substantive audit procedures.

.04 External confirmation procedures frequently may be relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations in which external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include the following:

- Bank balances and other information relevant to banking relationships
- Inventories held by third parties at bonded warehouses for processing or on consignment
- Property title deeds held by lawyers or financiers for safe custody or as security
- Investments held for safekeeping by third parties or purchased from stockbrokers but not delivered at the balance sheet date
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants
- Accounts payable balances and terms

.05 Although external confirmations may provide relevant audit evidence relating to certain assertions, some assertions exist for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances than they do of their existence.

.06 The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.

.07 Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include the following:

- The confirming party's knowledge of the subject matter. Responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond. For example, the confirming party
    - — may not accept responsibility for responding to a confirmation request,
    - — may consider responding too costly or time consuming,
    - — may have concerns about the potential legal liability resulting from responding,
    - — may account for transactions in different currencies, or
    - — may operate in an environment in which responding to confirmation requests is not a significant aspect of day-to-day operations.

  In such situations, confirming parties may not respond, may respond in a casual manner, or may attempt to restrict the reliance placed on the response.
- The objectivity of the intended confirming party. If the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

.08 For purposes of this section, *accounts receivable* means

- the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business; and
- a financial institution's loans.

.09 External confirmation procedures may be ineffective when, based on prior years' audit experience or experience with similar entities

- response rates to properly designed confirmation requests will be inadequate; or
- responses are known or expected to be unreliable.

If the auditor has experienced poor response rates to properly designed confirmation requests in prior audits, the auditor may instead consider changing the manner in which the confirmation process is performed, with the objective of increasing the response rates, or may consider obtaining audit evidence from other sources.

.10 The auditor should use external confirmation procedures for accounts receivable, except when one or more of the following is applicable:

- The overall account balance is immaterial.
- External confirmation procedures for accounts receivable would be ineffective.
- The auditor's assessed level of risk of material misstatement at the relevant assertion level is low, and the other planned substantive procedures address the assessed risk. In many situations, the use of external confirmation procedures for accounts receivable and the performance of other substantive procedures are necessary to reduce the assessed risk of material misstatement to an acceptably low level.

Substantive Procedures Responsive to Significant Risks

.11 If the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.

.12 Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, a risk may exist that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts but also to confirm the details of the sales agreements, including date, any rights of return, and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of nonfinancial personnel in the entity regarding any changes in sales agreements and delivery terms.

Nature of Substantive Procedures

.13 Depending on the circumstances, the auditor may determine the following:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level, such as, for example, when the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

.14 Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. AU-C section 520 addresses the application of analytical procedures during an audit.

.15 The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included. For example, the auditor might inspect subsequent cash disbursements and compare them with the recorded accounts payable to determine whether any purchases had been omitted from accounts payable.

.16 Because the assessment of the risks of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

Substantive Analytical Procedures

.17 Analytical procedures can be effective

- for certain types of assertions (for example, the completeness assertion, which cannot be tested directly using a test of balances on recorded amounts).
- when the relationships between amounts are very predictable.
- when the data used to develop expectations based on the relationship are reliable.
- when relatively precise expectations can be developed.

.18 Analytical procedures can provide evidence supporting financial statement assertions and, thus, can be used as substantive tests. Because analytical procedures are often the least expensive tests, they may be used whenever practical.

.19 Whenever analytical procedures are applied as substantive tests, the auditor may apply the following procedures:

- Consider whether the relationship is plausible and predictable.
- Consider whether the data used for the comparison is reliable.
- 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.

.20 AU-C section 520 establishes standards and provides guidance on the design of substantive analytical procedures. A more in depth discussion of AU-C section 520 is provided in section 3155, "Analytical Procedures."

Timing of Substantive Procedures

Substantive Procedures Performed at an Interim Date

.21 If substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing

a. substantive procedures, combined with tests of controls for the intervening period, or

b. if the auditor determines that it is sufficient, further substantive procedures only,that provide a reasonable basis for extending the audit conclusions from the interim date to the period-end. The following table summarizes factors that may be considered when determining whether to perform substantive procedures at an interim date.

Matters to Consider in Determining Whether to Perform Substantive Procedures at an Interim Date

	Likelihood of Performing Substantive Procedures at an Interim Date	
Factor to consider	*More likely*	*Less likely*
Control environment and other relevant controls	Effectively designed or operating controls, including the control environment	Ineffectively designed or operating controls, including the control environment
The availability of information for the remaining period	Information is available that will allow the auditor to perform procedures related to the remaining period	Lack of information necessary to perform procedures related to the remaining period
Assessed risk	Lower risk of material misstatement for the relevant assertion	Higher risk of material misstatement for the relevant assertion
Nature of transactions or account balances and relevant assertions	Year-end balances are reasonably predictable with respect to amount, relative significance, and composition	Year-end balances can fluctuate significantly from interim balances, for example, due to rapidly changing business conditions, seasonality of business, or transactions that are subject to management's discretion
Ability to perform audit procedures to cover remaining period	The auditor will be able to perform all necessary procedures to cover the remaining period	The auditor's ability to perform procedures relating to the remaining period is limited, for example, by a lack of available information

.22 The objective of some of the tests may make the results of the tests irrelevant if performed at an interim date. For example, tests related to the preparation of the financial statements or the client's compliance with debt covenants typically provide relevant audit evidence only if performed at the period end.

.23 In addition to those items described in the preceding table, the circumstances of the engagement may result in the performance of certain tests at an interim date. For example, a client may request that the auditor identify all material misstatements a short period of time after year end (which is common for companies that plan to issue a press release of their earnings for the period). In that situation, the auditor may decide to confirm receivables prior to year end because the time period between the end of the period and the release of earnings is too short to allow the auditor to send and receive confirmations of customers and to complete the test work.

.24 In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date and compare and reconcile information concerning the balance at the period-end with the comparable information at the interim date to

- identify amounts that appear unusual,
- investigate any such amounts, and
- perform substantive analytical procedures or tests of details to test the intervening period.

.25 Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period-end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The effectiveness of the control environment and other relevant controls
- The availability at a later date of information necessary for the auditor's procedures
- The purpose of the substantive procedure
- The assessed risk of material misstatement
- The nature of the class of transactions or account balance and relevant assertions
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period-end will not be detected

.26 In circumstances in which the auditor has identified risks of material misstatement due to fraud, the auditor's responses to address those risks may include changing the timing of audit procedures. For example, the auditor might conclude that, given the risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period-end reporting date would not be effective. In such circumstances, the auditor might conclude that substantive procedures performed at or near the end of the reporting period best address an identified risk of material misstatement due to fraud.

.27 Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period-end:

- Whether the period-end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition
- Whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and establishing proper accounting cutoffs are appropriate
- Whether the information system relevant to financial reporting will provide information concerning the balances at the period-end and the transactions in the remaining period that is sufficient to permit investigation of the following:
    - — Significant unusual transactions or entries (including those at or near the period-end)
    - — Other causes of significant fluctuations or expected fluctuations that did not occur
    - — Changes in the composition of the classes of transactions or account balances

.28 If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor should evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to bemodified. Also, see paragraphs .35–.36 of AU-C section 240.

.29 When the auditor concludes that the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating, at the period-end, the procedures performed at the interim date.

Substantive Procedures Performed in Previous Audits

.30 In most cases, audit evidence from substantive procedures performed in a prior audit provides little or no audit evidence for the current period. However, exceptions exist (for example, a legal opinion obtained in a previous audit related to the structure of a securitization to which no changes have occurred may be relevant in the current period). In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed and audit procedures have been performed during the current period to establish its continuing relevance.

Extent of the Performance of Substantive Procedures

.31 The greater the risks of material misstatement, the greater the extent of the auditor's substantive procedures. However, the nature of the audit procedures is of most importance in responding to assessed risks. Increasing the extent of an audit procedure is appropriate only if the procedure itself is relevant to the specified risk.

.32 *Considerations for designing tests of details.* When determining the extent of the tests of details, the auditor ordinarily thinks in terms of sample size. However, the auditor also may consider other matters, including whether it is more effective to use other methods of selecting items for testing, such as selecting large or unusual items from a population, rather than performing sampling or stratifying the population into homogeneous subpopulations for sampling. AU-C section 530 and the AICPA Audit Guide *Audit Sampling* establish requirements and provide guidance on the use of sampling and other means of selecting items for testing. AU-C section 530 and the use of sampling in an audit is discussed in section 5400, "Audit Sampling Considerations."

Adequacy of Presentation and Disclosure

.33 Section 5100, "Audit Evidence and Designing Further Audit Procedures," provides additional discussion regarding the auditor's evaluation of the overall presentation of the financial statements, including the related disclosures.

Evaluating the Sufficiency and Appropriateness of Audit Evidence

.34 Section 5100 provides additional discussion regarding the auditor's evaluation of the sufficiency and appropriateness of audit evidence obtained.

Documentation

.35 Section 5100 provides additional discussion regarding audit documentation requirements.

[*The next page is 5401.*]

AAM Section 5400

Audit Sampling Considerations

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 230, *Audit Documentation*
- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 300, *Planning an Audit*
- AU-C section 320, *Materiality in Planning and Performing an Audit*
- AU-C section 450, *Evaluation of Misstatements Identified During the Audit*
- AU-C section 500, *Audit Evidence*
- AU-C section 530, *Audit Sampling*

Selecting Items for Testing to Obtain Audit Evidence

.01 Once an auditor decides what audit procedures to apply (the nature of the tests) and when to apply them (the timing of the tests), the next decision to be made is to determine how many items to apply which procedures to—that is, the extent of testing. The greater the risks of material misstatement, the less detection risk that can be accepted, and, consequently, the greater the extent of substantive procedures. Because the risks of material misstatement include consideration of the effectiveness of internal control, the extent of substantive procedures may be reduced by satisfactory results from tests of the operating effectiveness of controls. However, the extent of an audit procedure is relevant only if the audit procedure itself is relevant to addressing the specific risk.

.02 In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are relevant, including whether it is more effective to use other selective means of testing. In addition, some auditing procedures may not involve sampling such as assessing the competency of the entity's accounting staff.

.03 An effective test provides appropriate audit evidence to the extent that it will be sufficient for the auditor's purpose when taken with other audit evidence obtained or to be obtained. In selecting items for testing, the auditor is required by AU-C section 500 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting the number of items to test. The means available to the auditor for selecting items for testing are

- selecting all items (100 percent examination),
- selecting specific items, and
- audit sampling.

.04 The application of any one or combination of these means may be appropriate depending on the particular circumstances (for example, the risks of material misstatement related to the assertion being tested and the practicality and efficiency of the different means).

Selecting All Items

.05 The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). A 100 percent examination is unlikely in the case of tests of controls; however, it may be more common for tests of details. A 100 percent examination may be appropriate when, for example

- the population constitutes a small number of large value items,
- a significant risk exists and other means do not provide sufficient appropriate audit evidence, or
- the repetitive nature of a calculation or other process performed automatically by an information system makes a 100 percent examination cost effective.

Selecting Specific Items

.06 The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to nonsampling risk. Specific items selected may include

- high value or key items. The auditor may decide to select specific items within a population because they are of high value (for example, sampling risk is not acceptable) or exhibit some other characteristic (for example, items that are suspicious, unusual, particularly risk prone, or have a history of error).
- all items over a certain amount. The auditor may decide to examine items whose recorded values exceed a certain amount in order to verify a large proportion of the total amount of a class of transactions or account balance (and applying other procedures to the remaining items if they are not significant).
- items to obtain information. The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

.07 Although selective examination of specific items from a class of transactions or account balance often will be an efficient means of obtaining audit evidence, it does not constitute audit sampling. Consequently, the results of audit procedures applied to items selected in this way cannot be projected to the entire population; furthermore, selective examination of specific items does not, by itself, provide sufficient appropriate audit evidence concerning the remainder of the population.

Audit Sampling

.08 Audit sampling is the selection and evaluation of less than 100 percent of the population of audit relevance such that the auditor expects the items selected (the sample) to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. It is often used to evaluate some characteristic of a balance or class of transactions and to obtain audit evidence. Auditors may use either nonstatistical or statistical sampling. Audit sampling is discussed in AU-C section 530.

.09 Valid conclusions ordinarily may be drawn using sampling approaches. However, if the sample size is too small, the sampling approach or the method of selection is not appropriate to achieve the specific audit objective or exceptions are not appropriately followed up, an unacceptable risk will exist that the auditor's conclusion based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure. AU-C section 530 addresses planning, performing, and evaluating audit samples.

Authoritative Standards

.10 AU-C section 530 addresses a variety of issues relating to the auditor's use of sampling in an audit engagement. However, AU-C section 530 does not always apply when the auditor is examining less than 100 percent of a population. The AICPA Audit Guide *Audit Sampling* presents recommendations on the application of generally accepted auditing standards (GAAS) to audits involving the use of audit sampling methods, and provides guidance to help auditors apply audit sampling in accordance with AU-C section 530.

When AU-C Section 530 Applies

.11 Audit sampling is only one of many tools used by auditors to obtain sufficient, appropriate audit evidence to support an opinion on financial statements. AU-C section 530 discusses design, selection, and evaluation considerations to be applied by the auditor when using audit sampling. As a general rule, audit sampling can be used

- in tests of controls to evaluate the operating effectiveness of prescribed controls,
- in substantive tests of details of account balances and classes of transactions, and
- in dual purpose tests that assess control risk and test whether the monetary amount of a recorded balance or class of transactions is correct.

.12 The portion of AU-C section 530 pertaining to tests of controls applies when sampling techniques are used to assess the effectiveness of controls (that is, control risk). The portion pertaining to substantive tests apply when sampling techniques are used to test details of transactions or balances.

.13 According to AU-C section 530, sampling occurs when the auditor tests less than 100 percent of a population for the purpose of evaluating some characteristic of an account balance or class of transactions. AU-C section 530 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. Also, if the sampling populations are small, it could be 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 increases, the auditor may determine to use audit sampling to perform tests of controls and tests of balances.

.14 In determining whether AU-C section 530 is applicable to circumstances in which an auditor examines less than 100 percent of the items making up an account balance or class of transactions, the auditor should consider the purpose of the test. AU-C section 530 establishes standards and provides guidance regarding the auditor's use of statistical and nonstatistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample. For example, if the auditor intends to examine selected sales invoices to draw a conclusion about whether sales are overstated, audit sampling as described in AU-C section 530 is applied because the auditor intends to draw a conclusion about all sales. On the other hand, if the auditor selects several large sales invoices for certain audit tests and then applies analytical procedures to assess the accuracy and valuation of the remaining invoices, the auditor is not sampling according to AU-C section 530—the examination of the large items is not intended to lead the auditor to a conclusion about the other items. In that case, any conclusion about whether sales are overstated is based on the results of the test of large sales invoices, inquiry and observations, analytical procedures, and other auditing procedures performed on the smaller items related to overstatement of sales. However, in practice, it is difficult to attain a high level of audit evidence regarding a significant aggregate amount of smaller items in the population from procedures other than sampling, such as analytical tests.

.15 The way in which the population is defined can determine whether the requirements of AU-C section 530 apply. The auditor might choose to divide a single reporting line on the financial statements into several populations. For example, accounts receivable might be divided into wholesale receivables, retail receivables, and employee receivables. Each of these populations can be tested using a different audit strategy—some using audit sampling and others not. The sampling concepts in AU-C section 530 apply only to populations for which audit sampling is used. Use of audit sampling on one population does not mandate its use on remaining populations. In addition, the auditor usually considers the assertions being addressed by the procedures because different procedures may provide different levels of audit evidence concerning different assertions.

Authoritative Guidance About the Application of Audit Sampling to Substantive Tests Provided by AU-C Section 530

.16 AU-C section 530 contains the following provisions regarding sampling in connection with substantive testing:

- The concept that some items exist which, in the auditor's judgment, acceptance of some sampling risk is not justified, and therefore should be examined 100 percent (see paragraph .A15 of AU-C section 530). This simply reminds the auditor that some of the items encountered in an examination of financial statements may be so significant individually or may have such a high likelihood of being in error or misstated that *all* such items should be examined.
- The suggestion that the efficiency of a sample may be improved by separating items subject to sampling into relatively homogeneous groups based on some characteristic (see paragraph .A11 of AU-C section 530). This indicates that audit efficiency can sometimes be improved by, for example, stratifying or segregating the items constituting a balance or class of transactions into groups based on individual dollar value or some other characteristic.
- Paragraph .07 of AU-C section 530 establishes a requirement that the auditor determine a sample size sufficient to reduce sampling risk to an acceptably low level. The level of sampling risk that the auditor can accept in the context of the audit strategy affects the sample size required. The lower the risk the auditor is able to accept, the greater the sample size necessary. Various factors typically influence determination of sample size, as follows:
- For substantive tests of details:
    - The auditor's desired level of assurance (complement of risk of incorrect acceptance) that tolerable misstatement is not exceeded by actual misstatement in the population; the auditor may decide the desired level of assurance based on the following:
        - The auditor's assessment of the risk of material misstatement
        - The assurance obtained from other substantive procedures directed at the same assertion
        - Tolerable misstatement
        - Expected misstatement for the population
        - Stratification of the population when performed
        - For some sampling methods, the number of sampling units in each stratum
- Paragraph .08 of AU-C section 530 establishes a requirement that the auditor selects a sample that can reasonably be expected to be representative of the relevant population. Simply put, this means that each item in the population being sampled should have *a chance* of being selected, not necessarily *an equal chance* of being selected. This does not mean that the auditor should use a random or probability sample, but that he or she should use a method that avoids bias (for example, selecting only simple transactions for testing). The AICPA Audit Guide *Audit Sampling* defines the term *representative*, in the context of sampling, as an evaluation of the sample that will result in conclusions that, subject to the limitations of sampling risk, are similar to those that would be drawn if the same procedures were applied to the entire population.
- Paragraph .09 of AU-C section 530 establishes a requirement that the auditor should perform audit procedures, appropriate to the purpose, on each item selected.

- Paragraph .10 of AU-C section 530 establishes a requirement that if the audit procedure is not applicable to the selected item, the auditor should perform the procedure on a replacement item. For example, when a voided check is selected while testing for evidence of payment authorization, if the auditor is satisfied that the check has been properly voided such that it does not constitute a deviation, an appropriately chosen replacement is examined.
- Paragraph .11 of AU-C section 530 establishes a requirement that if the auditor is unable to apply planned audit procedures, or suitable alternative procedures, to a selected item, the auditor should treat that item as a deviation from the prescribed control (in the case of tests of controls) or a misstatement (in the case of tests of details). For example, sometimes the auditor may not be able to apply planned audit procedures to selected sample items because the entity may not be able to locate supporting documentation. The auditor's treatment of unexamined items will depend on their effect on the auditor's evaluation of the sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it may not be necessary to examine the items (that is, if the aggregate amount of the unexamined items, if treated as misstatements or deviations, would not cause the auditor's assessment of the amount of the misstatement or deviation in the population to exceed tolerable misstatement or tolerable deviation, respectively). However, when this is not the case, the auditor is required to perform alternative procedures that provide sufficient appropriate audit evidence to form a conclusion about the sample item and use the results of these procedures in assessing the sample results. If alternative procedures cannot be satisfactorily performed in these cases, the auditor is required to treat the items as misstatements or deviations, as appropriate, in evaluating the results of the sample. AU-C section 240 also requires the auditor to consider whether the reasons for the auditor's inability to examine the items have implications with regard to assessing risks of material misstatement due to fraud, the assessed level of control risk that the auditor expects to be supported, or the degree of reliance on management representations.
- Paragraph .12 of AU-C section 530 establishes a requirement that the auditor should investigate the nature and cause of any deviations or misstatements identified and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature (for example, type of transaction, location, product line, or period of time). In such circumstances, the auditor may decide to identify all items in the population that possess the common feature and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional and may indicate the possibility of fraud. In addition to the evaluation of the frequency and amounts of monetary misstatements, AU-C section 450 requires the auditor to consider the qualitative aspects of the misstatements. These include (*a*) the nature and cause of misstatements, such as whether they are differences in principle or application, are errors, or are caused by fraud or are due to misunderstanding of instructions or carelessness, and (*b*) the possible relationship of the misstatements to other phases of the audit. The discovery of fraud requires a broader consideration of possible implications than does the discovery of an error.
- Paragraph .13 of AU-C section 530 establishes a requirement that the auditor should project the misstatement results of audit sampling to the population. Because the sample is expected to be representative of the population from which it was selected, misstatements found are also expected to be representative of the population. In this context, the term *representative* relates to the frequency and magnitude of the misstatements, and not necessarily to their nature. Tracing a misstatement to a specific cause (for example, the bookkeeper was on vacation) is not sufficient to exclude the misstatement from the projection of a sample. The AICPA Audit Guide *Audit Sampling* provides discussion of when a misstatement might be treated differently from other misstatements identified in the population. For tests of details, the auditor is required to project misstatements observed in an audit sample to the population in order to obtain a likely misstatement. Due to sampling risk caused by the small size of some samples, this projection may not be sufficient to determine an amount to be recorded. For tests of controls, the sample deviation rate is also the projected deviation rate for the population as a whole.

- Paragraph .14 of AU-C section 530 establishes a requirement that the auditor should evaluate (*a*) the results of the sample, including sampling risk, and (*b*) whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

Documentation Requirements

.17 AU-C section 530 itself contains no documentation requirements specific to audit sampling, but there are some documentation requirements established by paragraph .12 of AU-C section 450. However, the documentation standards set forth in the AICPA *Professional Standards* regarding documentation apply to audit sampling applications just as they apply to other auditing procedures. AU-C section 300 states that the auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and that guides the development of the audit plan, and AU-C section 230 states that the auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand (*a*) the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements; (*b*) the results of the audit procedures performed, and the audit evidence obtained; and (*c*) significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

.18 The identification of the items tested may be satisfied by indicating the source from which the items were selected and the specific selection criteria. For example,

- when a haphazard or random sample is selected, the documentation should include identifying characteristics (for example, the specific invoice numbers of the items included in the sample);
- when all items over a specified dollar amount are selected from a listing, the documentation need describe only the scope and the identification of the listing (for example, all invoices over $25,000 from the December sales journal); and
- when a systematic sample is selected from a population of documents, the documentation need only provide an identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of shipping reports was selected from the shipping log for the period from X to Y, starting with report number 14564 and selecting every 250th report from that point).

With regard to audit sampling applications, the audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. Examples of items that the auditor may document for tests of controls are discussed in paragraph .34 of this section. Examples of items that the auditor typically documents for substantive tests are discussed in paragraph .68 of this section.

Determining Extent of Testing Without Sampling in a Small Business Audit[1]

.19 Small businesses have certain characteristics that may influence the auditor's decision to use audit sampling.

.20 For substantive testing, small businesses frequently have small populations of accounting data in both account balances and classes of transactions. Consequently, sampling may not be necessary when the necessary audit assurance is attained by examining a significant portion or aggregate value of all the transactions. When sampling is still appropriate, very small populations may allow for reduced sample sizes when compared to the sample sizes indicated in tables or formulas designed for large populations.

.21 The definition of audit sampling in paragraph .05 of AU-C section 530 allows some alternative approaches to sampling to determine the extent of testing in a small business engagement. These alternatives, by not using audit sampling and thus eliminating the requirements of AU-C section 530, may provide a more effective and efficient audit approach for a small business engagement.

[1] The concepts discussed in this section can also be applied to certain less complex account balances and classes of transactions in more complex entities.

.22 These alternative approaches include the following:

- Procedures applied to 100 percent of a certain group (strata) of transactions or balances
- Testing unusual items/specific items without applying procedures to the remainder of the population (for example, when the remaining population is not material)
- Other tests that involve application of procedures to less than 100 percent of the items in the population without drawing a conclusion about the entire account or class of transactions

.23 The auditor should decide what audit procedures to perform to meet the established audit objectives. Once this decision is made, the auditor should determine the extent of testing.

.24 An effective and efficient approach to determining the extent of testing in a small business engagement is shown in flowchart 1. This approach involves four important steps.

Identification of Individual Items to Be Examined

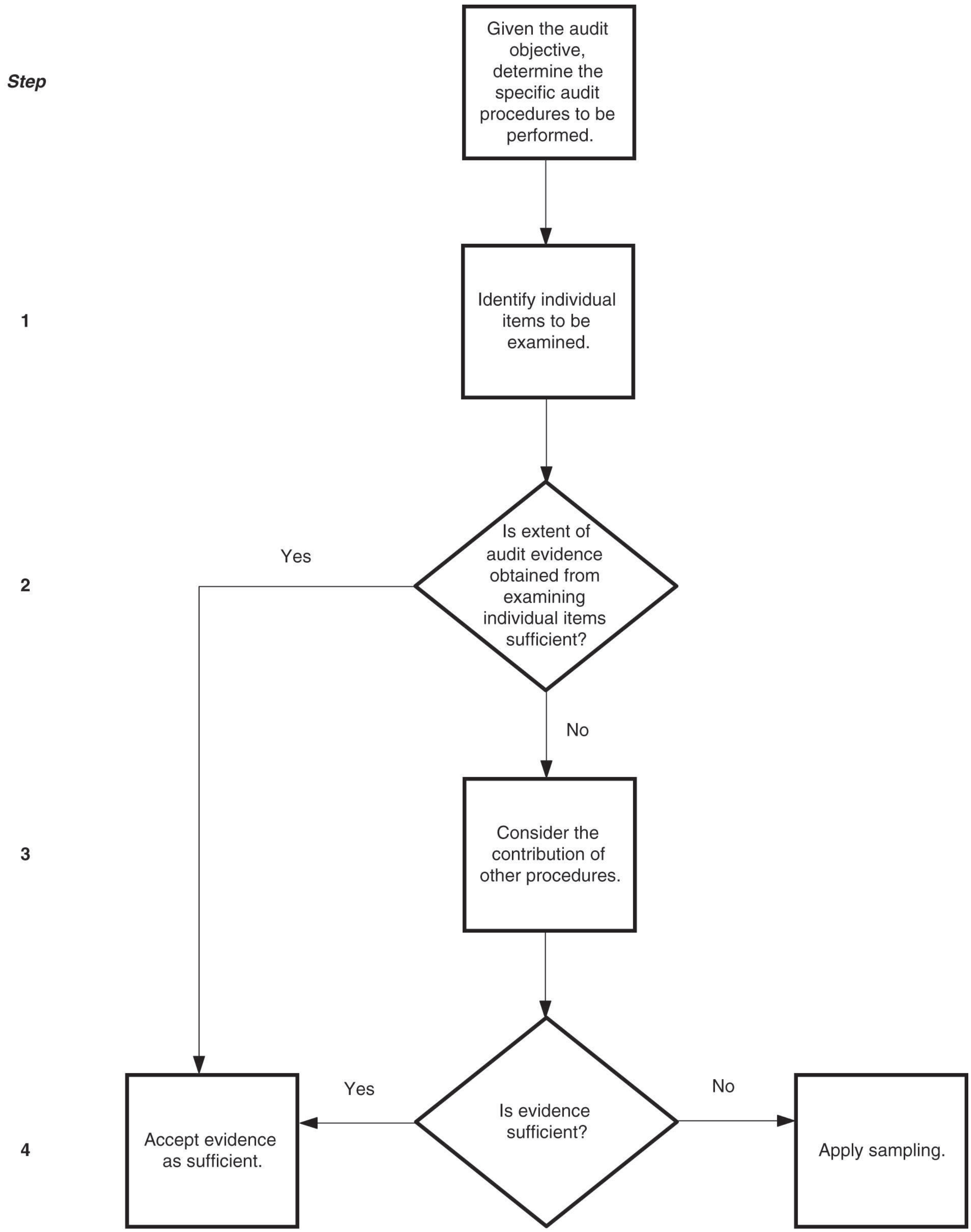
.25 The auditor is required to apply professional judgment in determining which individual items in an account balance or class of transactions need to be examined. In evaluating individual items, the auditor may consider factors such as the size of the item, whether the item is unusual, prior experience with the client, and whether the item involves a related party.

.26 For example, consider the following information for accounts receivable of a small business.

Number of Accounts	*Balances*	*Total Accounts*
4	$100,000 or more	$ 625,000
7	$25,000–99,999	375,000
62	$1–24,999	300,000
73		$1,300,000

In this case, if the 11 largest accounts are confirmed by the auditor, most of the accounts receivable balance is supported ($1,000,000 out of $1,300,000, or 77 percent). Provided the remaining $300,000 is not greater than tolerable misstatement or can be tested through other audit procedures (for example, subsequent receipts or analytical procedures), it may not be necessary to design a sample of the remaining items. Also, the auditor may decide to confirm the receivables that have unusual characteristics (for example, receivables with either large credit balances or those that are very delinquent).

Flowchart 1
A Small Business Audit Sampling Approach



Is Extent of Audit Evidence Obtained Sufficient?

.27 The following are some factors in evaluating the sufficiency of audit evidence obtained in tests of details for a particular account balance or class of transactions:

- The individual importance of the items examined. If the items examined, account for a high percentage of the total population, then the auditor may be reasonably assured that there is an acceptably low risk of an undetected misstatement.
- The nature and cause of misstatements. If during the course of the audit, misstatements are discovered, those misstatements should be evaluated to determine if they are due to differences in principle or in application, are errors or fraud or are due to misunderstanding of instructions or carelessness.
- Possible relationship of the misstatement to other phases of the audit. If it is determined that the misstatement is due to fraud, this would ordinarily require a broader consideration of the possible implications than would the discovery of an error. If the misstatement indicates a control deficiency, does that deficiency indicate a need to alter the planned audit strategy (for example, reduce reliance on controls)?
- The characteristics of the sample to the population. The auditor may obtain some knowledge of the types of items in the population if the characteristics in the sample are similar in nature and the same controls are followed for processing the transactions.

Consider Contribution of Other Procedures

.28 The auditor may also consider whether other evidence obtained contributes to conclusions regarding the account balance or class of transactions. The auditor often considers the contribution of other procedures at the same time the extent of audit evidence obtained from examining individual items is considered.

.29 The auditor may use a combination of analytical procedures and substantive tests of details to support an opinion on the financial statements. In deciding whether other audit procedures make a contribution, the auditor may consider whether they support the audit objectives in the area, whether they indicate potential problems, and whether the evidence is consistent with the previous evidence obtained. In addition, the procedures performed by others (for example, internal auditors or regulators) may also contribute to the evidence supporting the relevant assertions.

.30 In considering the contribution of other procedures, the auditor should use professional judgment in determining whether an unmodified opinion can be given without performing additional tests in the form of audit sampling.

Evaluation of Sufficiency of Evidence

.31 There are four factors that the auditor may consider in evaluating the sufficiency of audit evidence obtained from examining individual items and contributed by other procedures, and in determining whether the remaining items in the population should be tested.

.32 First, the auditor may consider whether the dollar amount of the remaining population is equal to or greater than an amount that would individually or in combination with other untested amounts be material to the financial statements. If the remaining population is less than material, the auditor may decide that no additional sampling is necessary, but may consider whether other procedures can provide sufficient assurance that any misstatement of the remaining population is not significant. Second, the auditor may consider the degree of risk involved (that is, how susceptible the account is to misstatement, and whether there have been problems with this area in prior audits). Third, the auditor may consider the sufficiency of all the audit evidence obtained so far (the extent of audit evidence obtained by testing individual items along with the contribution of other procedures). The final factor is the qualitative aspects of the misstatement. These include (*a*) the nature and cause of misstatements, such as whether there are differences in principle or in application, are errors or are caused by fraud, or are due to misunderstanding of instructions or to carelessness, and (*b*) the possible relationship of the misstatements to other phases of the audit. The discovery of fraud ordinarily requires a broader consideration of possible implications than does the discovery of an error.

.33 Section 5100, "Audit Evidence and Designing Further Audit Procedures," provides additional discussion regarding the auditor's evaluation of the sufficiency and appropriateness of audit evidence obtained.

Audit Sampling for Tests of Controls

.34 AU-C section 530 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This section 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:

- *Determine the objective of the test*. The objective of tests of controls is to provide evidence about the operating effectiveness of controls. Audit sampling for tests of controls is generally appropriate when application of the control 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 controls were applied. Tests of controls involving observation of performance of procedures, inquiries of the client, or evaluations of some control environment objectives (for example, accounting competence) are not normally subject to audit sampling. As with any test, it should be related to a relevant assertion.
- *Define the deviation conditions*. A deviation condition is a situation that indicates that a control or controls were not performed as expected by the auditor. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (for example, the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Performance of a control consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed control 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 control 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.'"
- *Define the population*. The population consists of the items constituting the account balance or class of transactions of interest. The auditor should determine that the population from which the sample is selected is appropriate for the specific audit objective being tested because sample results can be projected only to the population from which the sample was selected. For example, if the auditor is testing the operating effectiveness of a prescribed control designed to ensure that 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.
- *Define the period covered by the test*. For samples to be representative of the period under audit, the population generally includes all transactions processed during the period under audit. Often, auditors perform tests of controls during interim work. The auditor should determine what additional evidence needs to be obtained for the remaining period. Often, the auditor obtains the additional evidence by extending the test to the transactions occurring in the remaining period. However, it is not always efficient to include all transactions executed throughout the period under audit in the population to be sampled. In some cases, it might be more efficient to use alternative approaches to test the performance of the control during the remaining period. In these cases the auditor would define the population to include transactions for the period from the beginning of the year to an interim date and consider the following factors in determining what, if any, additional evidence needs to be obtained for the remaining period:
    - The significance of the assessed risks of material misstatement at the relevant assertion level
    - The specific controls that were tested during the interim period and the results of those tests

- Significant changes to the controls since they were tested, including changes in the information system, processes, and personnel
- The degree to which audit evidence about the operating effectiveness of those controls was obtained
- The length of the remaining period
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls
- The effectiveness of the control environment

The auditor selects sampling units from a physical representation of the population. For example, if the auditor defines the population as all customer receivable balances as of a specific date, the physical representation might be a printout of the customer accounts receivable trial balance as of that date or an electronic file purportedly containing the customer balances. Making selections from a controlled source minimizes differences between the physical representation and the population. The auditor should consider whether the physical representation includes the entire population. If the auditor reconciles the selected physical representation and the population and determines that the physical representation has omitted items in the population that should be included in the overall evaluation, the auditor should select a new physical representation or perform alternative procedures on the items excluded from the physical representation.

- *Define the sampling unit*. The sampling unit may be defined in light of the control being tested. A sampling unit may be, for example, a document, an entry, or a line item, where examination of the sampling unit provides evidence of the operation of the control. An important efficiency consideration in selecting a sampling unit is the manner in which documents are filed and cross-referenced.
- *Determine the method of selecting the sample*. Any sample that is selected should be representative of the population (selected in an unbiased manner) and all items should have an opportunity to be selected. For statistical sampling, it is necessary to use an appropriate random sampling method such as simple random sampling or systematic random sampling. When nonstatistical sampling is applied, random number sampling, systematic sampling, haphazard sampling, and block sampling are methods that might be used to obtain a representative sample. When block sampling is used a representative sample of blocks are often necessary for effective conclusions. *Determine the sample size*. Sample sizes for tests of controls are affected by (*a*) the desired level of assurance (complement of risk of overreliance) that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population, (*b*) the tolerable rate of deviation, (*c*) the expected rate of deviation of the population to be tested, and (*d*) any effects of small population sizes.
- Guidance for determining sample size when performing nonstatistical sampling begins with paragraph .37 of this section. A description of statistical sampling begins with paragraph .40 of this section.
- *Perform the sampling plan*. Once the sample has been selected, the auditor should examine the selected items to determine whether they contain deviations from the prescribed control. If the auditor selects a voided item, and the auditor obtains evidence that the item has been properly voided and does not represent a deviation from the prescribed control, he or she should replace the voided item. If the auditor selects an unused item, he or she would typically obtain evidence that the item actually represents an unused item, not a deviation from the prescribed control, and then replace the unused item. If the auditor is unable to examine a selected item because it cannot be located or for any other reason, and the auditor is unable to apply the planned audit procedures or appropriate alternative procedures to selected items, he or she should consider the selected items to be deviations from the controls for purposes of evaluating the sample. In addition, the auditor should consider the reasons for this limitation and the effect that such a limitation might have on his or her understanding of internal control and assessment of control risk.
- *Evaluate the sample results*. Guidance for evaluating nonstatistical sampling results begins with paragraph .39 of this section and guidance for evaluating statistical sampling results begins with paragraph .41 of this section.

- *Document the sampling procedure*. Examples of items that the auditor may document for tests of controls that involve audit sampling include the following:
    - — A description of the control being tested.
    - — The control objectives related to the sampling application, including the relevant assertions.
    - — The definition of the population (the source from which the items were selected) and the sampling unit, including how the auditor considered the completeness of the population.
    - — The definition of the deviation condition.
    - — The acceptable risk that controls are more effective than they actually are (that is, the risk of overreliance on controls [or desired confidence or assurance level]), the tolerable rate of deviation, and the expected population deviation rate used in the application.[2]
    - — The method of sample-size determination.
    - — The method of sample selection.
    - — The selected sample items.
    - — A description of how the sampling procedure was performed.
    - — The evaluation of the sample and the overall conclusion.

.35 *Factors affecting sample sizes for tests of controls.* Sample sizes for tests of controls are affected by the following factors:

- *Acceptable risk of overreliance*. The risk of overreliance is the risk that the assessed level of control risk based on the sample is less than the true operating effectiveness of the control. Decreasing the risk of overreliance will increase the sample size.
- *Expected population rate of deviation.* The expected population deviation rate is an anticipation of the deviation rate in the entire population. As the expected population deviation rate increases, the sample size will increase.
- *Tolerable rate of deviation.* Tolerable rate is the maximum rate (percentage) of deviation from a prescribed control that the auditor is willing to accept without altering the planned assessed level of control risk. Higher tolerable rates will permit smaller sample sizes.
- *Population size.* The size of the population has little or no effect on the determination of sample size except for very small populations. For example, it is generally appropriate to treat any population of more than 2,000 sampling units as if it were infinite. If the population size is under 2,000 sampling units, the population size may have a small effect on the calculation of the sample size.

.36 The effects of these factors on the appropriate nonstatistical sample size may be summarized as follows:

Factor	*General Effect on Sample Size*
Risk of overreliance—increase (decrease)	Smaller (larger)
Tolerable rate—increase (decrease)	Smaller (larger)
Expected population deviation rate—increase (decrease)	Larger (smaller)
Population size	Virtually no effect

.37 *Sample sizes using nonstatistical sampling.* The auditor using nonstatistical sampling for tests of controls uses his or her professional judgment to consider the factors described in paragraph .35 of this section in determining sample sizes.

[2] In some instances, sample size inputs such as acceptable risk of overreliance, tolerable rate of deviation, and expected deviation rate are built into firm-wide sample size tables. In these instances, reference to firm sample size guidance is sufficient (that is, each team does not need to document inputs that are implicit in the firm's sample size tables).

.38 Paragraph .07 of AU-C section 530 states that the auditor should determine a sample size sufficient to reduce sampling risk to an acceptably low level. The level of sampling risk that the auditor is willing to accept (and is congruent with the audit strategy and the evidence obtained or expected to be obtained from other sources) affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size necessary. The sample size can be determined by the application of a statistically based formula or tables or professional judgment that relates the various component factors to sample sizes. An adequate sample size is usually comparable to a well-designed statistical sample size considering these same factors. Various factors typically influence determination of sample size for test of controls, as follows:

- The tolerable rate of deviation of the population to be tested
  - — The expected rate of deviation of the population to be tested
  - — The desired level of assurance (complement of risk of overreliance) that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population; the auditor may decide the desired level of assurance based on the extent to which the auditor's risk assessment takes into account relevant controls
  - — The number of sampling units in the population (if the population is very small)

It is important to note, however, that auditors are not required to specifically compute a statistical sample size. Nevertheless, auditors might find it helpful to be familiar with the tables in paragraphs .42–.45 of this section. Auditors using these tables as an aid in understanding relative sample sizes for tests of controls will need to apply professional judgment in reviewing the risk levels and expected population deviation rates in relation to sample sizes. Also, an auditor may decide to establish guidelines for sample sizes for tests of controls based on attribute sampling tables or formulae.

.39 After completing the examination of the sampling units and summarizing deviations from prescribed controls, the auditor evaluates the results.

- *Calculate the deviation rate*. Calculating the deviation rate in the sample involves dividing the number of observed deviations by the sample size.
- *Consider sampling risk*. When evaluating a sample for a test of controls, consideration may be given to sampling risk. If the deviation rate exceeds the rate considered in planning the sample, then the sample may not have met the desired risk and precision.
- *Consider the qualitative aspects of deviations*. In addition to evaluating the frequency of deviations from pertinent controls, the auditor should consider the qualitative aspects of the deviations.
- *Reach an overall conclusion*. The auditor uses professional judgment to reach an overall conclusion about the effect that the evaluation of the results will have on the assessed level of control risk and on the nature, timing and extent of planned substantive tests.

.40 *Sample sizes using statistical sampling.* An appropriate statistical method for tests of controls is *attributes sampling*, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling is most commonly used in auditing to test the rate of deviation from a prescribed control to support the auditor's assessed level of control risk.

.41 Applying attributes sampling involves performing the following steps:

a. *Decide on the attributes to test*. The tests of controls may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.

b. *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 paragraph .34 of this section.

c. Specify the following factors:

- *Risk of overreliance*. There is an inverse relationship between the risk of overreliance on the control and sample size. If the auditor is willing to accept only a low control risk , the sample size would ordinarily be larger than if a higher risk were acceptable. When auditors seek significant evidence from important controls, the risk is often set at 10 percent or less.

- *Tolerable rate of deviation*. Higher assessments of control risk may permit higher tolerable rates of deviation. When auditors seek significant evidence (that is, high assurance) from important controls, the tolerable deviation rates are generally set at 10 percent or less.
- *Expected population deviation rate*. The auditor's expectations may be based on prior year's tests and the control environment. The prior year's results may be considered in light of changes in the entity's internal control and changes in personnel. 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.

d. Determine the appropriate sample size. Example sample sizes are found in the tables in paragraphs .42–.43 of this section. The table in paragraph .42 is designed for a risk of assessing control risk too low of 5 percent, and the table in paragraph .43 is designed for a 10 percent risk of assessing control risk too low. With the tolerable rate and the expected population 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.

e. Randomly select the sample from the population. For statistical sampling, it is necessary to use an appropriate random sampling method such as simple random sampling or systematic random sampling.

f. Perform the audit procedures to identify deviations in the sample.

g. Calculate the statistical results. Using the tables in paragraphs .44–.45 of this section and the acceptable risk of overreliance, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.

h. Reassess the level of control risk. If the sample results, along with other relevant evidential matter, support the planned assessed level of control risk, the auditor generally does not need to modify planned substantive tests. If the planned assessed level of control risk is not supported, the auditor would ordinarily either perform tests of other controls that could support the planned assessed level of control risk or increase the assessed level of control risk and may need to modify the audit strategy for that audit area.

*i. Document the sampling procedures.*AU-C section 530 and the AICPA Audit Guide *Audit Sampling* do not require specific documentation of audit sampling applications, but there are some documentation requirements established by paragraph .12 of AU-C section 450. See paragraph .17 of this section for certain documentation requirements of AU-C section 230. Examples of items that the auditor typically documents for tests of controls are discussed in paragraph .34 of this section. Auditors may also refer to the Audit Guide *Audit Sampling* for more information.

.42

Statistical Sample Sizes for Test of Controls—5 Percent Risk of Overreliance (With Number of Expected Errors in Parentheses)

	Tolerable Deviation Rate										
Expected Deviation Rate	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149 (0)	99 (0)	74 (0)	59 (0)	49 (0)	42 (0)	36 (0)	32 (0)	29 (0)	19 (0)	14 (0)
0.25%	236 (1)	157 (1)	117 (1)	93 (1)	78 (1)	66 (1)	58 (1)	51 (1)	46 (1)	30 (1)	22 (1)
0.50%	313 (2)	157 (1)	117 (1)	93 (1)	78 (1)	66 (1)	58 (1)	51 (1)	46 (1)	30 (1)	22 (1)
0.75%	386 (3)	208 (2)	117 (1)	93 (1)	78 (1)	66 (1)	58 (1)	51 (1)	46 (1)	30 (1)	22 (1)
1.00%	590 (6)	257 (3)	156 (2)	93 (1)	78 (1)	66 (1)	58 (1)	51 (1)	46 (1)	30 (1)	22 (1)
1.25%	1,030 (13)	303 (4)	156 (2)	124 (2)	78 (1)	66 (1)	58 (1)	51 (1)	46 (1)	30 (1)	22 (1)
1.50%		392 (6)	192 (3)	124 (2)	103 (2)	66 (1)	58 (1)	51 (1)	46 (1)	30 (1)	22 (1)
1.75%		562 (10)	227 (4)	153 (3)	103 (2)	88 (2)	77 (2)	51 (1)	46 (1)	30 (1)	22 (1)
2.00%		846 (17)	294 (6)	181 (4)	127 (3)	88 (2)	77 (2)	68 (2)	46 (1)	30 (1)	22 (1)
2.25%		1,466 (33)	390 (9)	208 (5)	127 (3)	88 (2)	77 (2)	68 (2)	61 (2)	30 (1)	22 (1)
2.50%			513 (13)	234 (6)	150 (4)	109 (3)	77 (2)	68 (2)	61 (2)	30 (1)	22 (1)
2.75%			722 (20)	286 (8)	173 (5)	109 (3)	95 (3)	68 (2)	61 (2)	30 (1)	22 (1)
3.00%			1,098 (33)	361 (11)	195 (6)	129 (4)	95 (3)	84 (3)	61 (2)	30 (1)	22 (1)
3.25%			1,936 (63)	458 (15)	238 (8)	148 (5)	112 (4)	84 (3)	61 (2)	30 (1)	22 (1)
3.50%				624 (22)	280 (10)	167 (6)	112 (4)	84 (3)	76 (3)	40 (2)	22 (1)
3.75%				877 (33)	341 (13)	185 (7)	129 (5)	100 (4)	76 (3)	40 (2)	22 (1)
4.00%				1,348 (54)	421 (17)	221 (9)	146 (6)	100 (4)	89 (4)	40 (2)	22 (1)
5.00%					1,580 (79)	478 (24)	240 (12)	158 (8)	116 (6)	40 (2)	30 (2)
6.00%						1,832 (110)	532 (32)	266 (16)	179 (11)	50 (3)	30 (2)
7.00%								585 (41)	298 (21)	68 (5)	37 (3)
8.00%									649 (52)	85 (7)	37 (3)
9.00%										110 (10)	44 (4)
10.00%										150 (15)	50 (5)
12.50%										576 (72)	88 (11)
15.00%											193 (29)
17.50%											720 (126)

Note: Sample sizes over 2,000 items not shown. This table assumes a large population.

.43

Statistical Sample Sizes for Test of Controls—10 Percent Risk of Overreliance (With Number of Expected Errors in Parentheses)

	Tolerable Deviation Rate										
Expected Deviation Rate	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	114 (0)	76 (0)	57 (0)	45 (0)	38 (0)	32 (0)	28 (0)	25 (0)	22 (0)	15 (0)	11 (0)
0.25%	194 (1)	129 (1)	96 (1)	77 (1)	64 (1)	55 (1)	48 (1)	42 (1)	38 (1)	25 (1)	18 (1)
0.50%	194 (1)	129 (1)	96 (1)	77 (1)	64 (1)	55 (1)	48 (1)	42 (1)	38 (1)	25 (1)	18 (1)
0.75%	265 (2)	129 (1)	96 (1)	77 (1)	64 (1)	55 (1)	48 (1)	42 (1)	38 (1)	25 (1)	18 (1)
1.00%	398 (4)	176 (2)	96 (1)	77 (1)	64 (1)	55 (1)	48 (1)	42 (1)	38 (1)	25 (1)	18 (1)
1.25%	708 (9)	221 (3)	132 (2)	77 (1)	64 (1)	55 (1)	48 (1)	42 (1)	38 (1)	25 (1)	18 (1)
1.50%	1,463 (22)	265 (4)	132 (2)	105 (2)	64 (1)	55 (1)	48 (1)	42 (1)	38 (1)	25 (1)	18 (1)
1.75%		390 (7)	166 (3)	105 (2)	88 (2)	55 (1)	48 (1)	42 (1)	38 (1)	25 (1)	18 (1)
2.00%		590 (12)	198 (4)	132 (3)	88 (2)	75 (2)	48 (1)	42 (1)	38 (1)	25 (1)	18 (1)
2.25%		974 (22)	262 (6)	132 (3)	88 (2)	75 (2)	65 (2)	42 (1)	38 (1)	25 (1)	18 (1)
2.50%			353 (9)	158 (4)	110 (3)	75 (2)	65 (2)	58 (2)	38 (1)	25 (1)	18 (1)
2.75%			471 (13)	209 (6)	132 (4)	94 (3)	65 (2)	58 (2)	52 (2)	25 (1)	18 (1)
3.00%			730 (22)	258 (8)	132 (4)	94 (3)	65 (2)	58 (2)	52 (2)	25 (1)	18 (1)
3.25%			1,258 (41)	306 (10)	153 (5)	113 (4)	82 (3)	58 (2)	52 (2)	25 (1)	18 (1)
3.50%				400 (14)	194 (7)	113 (4)	82 (3)	73 (3)	52 (2)	25 (1)	18 (1)
3.75%				583 (22)	235 (9)	131 (5)	98 (4)	73 (3)	52 (2)	25 (1)	18 (1)
4.00%				873 (35)	274 (11)	149 (6)	98 (4)	73 (3)	65 (3)	25 (1)	18 (1)
5.00%					1,019 (51)	318 (16)	160 (8)	115 (6)	78 (4)	34 (2)	18 (1)
6.00%						1,150 (69)	349 (21)	182 (11)	116 (7)	43 (3)	25 (2)
7.00%							1,300 (91)	385 (27)	199 (14)	52 (4)	25 (2)
8.00%								1,437 (115)	424 (34)	60 (5)	25 (2)
9.00%									1,577 (142)	77 (7)	32 (3)
10.00%										100 (10)	38 (4)
12.50%										368 (46)	63 (8)
15.00%											126 (19)
17.50%											457 (80)

Note: Sample sizes over 2,000 items not shown. This table assumes a large population.

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Statistical Sampling Results Evaluation Table for Tests of Controls— Upper Limits at 5 Percent Risk of Overreliance

	Actual Number of Deviations Found										
Sample Size	0	1	2	3	4	5	6	7	8	9	10
20	14.0	21.7	28.3	34.4	40.2	45.6	50.8	55.9	60.7	65.4	69.9
25	11.3	17.7	23.2	28.2	33.0	37.6	42.0	46.3	50.4	54.4	58.4
30	9.6	14.9	19.6	23.9	28.0	31.9	35.8	39.4	43.0	46.6	50.0
35	8.3	12.9	17.0	20.7	24.3	27.8	31.1	34.4	37.5	40.6	43.7
40	7.3	11.4	15.0	18.3	21.5	24.6	27.5	30.4	33.3	36.0	38.8
45	6.5	10.2	13.4	16.4	19.2	22.0	24.7	27.3	29.8	32.4	34.8
50	5.9	9.2	12.1	14.8	17.4	19.9	22.4	24.7	27.1	29.4	31.6
55	5.4	8.4	11.1	13.5	15.9	18.2	20.5	22.6	24.8	26.9	28.9
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	20.8	22.8	24.8	26.7
65	4.6	7.1	9.4	11.5	13.6	15.5	17.5	19.3	21.2	23.0	24.7
70	4.2	6.6	8.8	10.8	12.7	14.5	16.3	18.0	19.7	21.4	23.1
75	4.0	6.2	8.2	10.1	11.8	13.6	15.2	16.9	18.5	20.1	21.6
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	20.3
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.9	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	13.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4
300	1.0	1.6	2.1	2.6	3.1	3.5	4.0	4.4	4.8	5.2	5.6
400	0.8	1.2	1.6	2.0	2.3	2.7	3.0	3.3	3.6	3.9	4.3
500	0.6	1.0	1.3	1.6	1.9	2.1	2.4	2.7	2.9	3.2	3.4

Note: This table presents upper limits (body of table) as percentages. This table assumes a large population

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Statistical Sampling Results Evaluation Table for Tests of Controls—Upper Limits at 10 Percent Risk of Overreliance

	Actual Number of Deviations Found										
Sample Size	0	1	2	3	4	5	6	7	8	9	10
20	10.9	18.1	24.5	30.5	36.1	41.5	46.8	51.9	56.8	61.6	66.2
25	8.8	14.7	20.0	24.9	29.5	34.0	38.4	42.6	46.8	50.8	54.8
30	7.4	12.4	16.8	21.0	24.9	28.8	32.5	36.2	39.7	43.2	46.7
35	6.4	10.7	14.5	18.2	21.6	24.9	28.2	31.4	34.5	37.6	40.6
40	5.6	9.4	12.8	16.0	19.0	22.0	24.9	27.7	30.5	33.2	35.9
45	5.0	8.4	11.4	14.3	17.0	19.7	22.3	24.8	27.3	29.8	32.2
50	4.6	7.6	10.3	12.9	15.4	17.8	20.2	22.5	24.7	27.0	29.2
55	4.2	6.9	9.4	11.8	14.1	16.3	18.4	20.5	22.6	24.6	26.7
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	20.8	22.7	24.6
65	3.5	5.9	8.0	10.0	12.0	13.9	15.7	17.5	19.3	21.0	22.8
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	18.0	19.6	21.2
75	3.1	5.1	7.0	8.7	10.4	12.1	13.7	15.2	16.8	18.3	19.8
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.7
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.7
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	13.9	15.0
125	1.9	3.1	4.3	5.3	6.3	7.3	8.3	9.3	10.2	11.2	12.1
150	1.6	2.6	3.6	4.4	5.3	6.1	7.0	7.8	8.6	9.4	10.1
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6
300	0.8	1.3	1.8	2.3	2.7	3.1	3.5	3.9	4.3	4.7	5.1
400	0.6	1.0	1.4	1.7	2.0	2.4	2.7	3.0	3.3	3.6	3.9
500	0.5	0.8	1.1	1.4	1.6	1.9	2.1	2.4	2.6	2.9	3.1

Note: This table presents upper limits (body of table) as percentages. This table assumes a large population

Audit Sampling for Substantive Tests of Details

.46 The purpose of substantive tests of details of transactions and balances is to detect material misstatements in the account balance, transaction class, and disclosure components of the financial statements. An auditor assesses the risks of material misstatement and uses a combination of further audit procedures to provide a basis for the opinion about whether the financial statements are materially misstated. When testing the details of an account balance or class of transactions, the auditor might use audit sampling to obtain evidence about the reasonableness of monetary amounts.

.47 Paragraphs .06 and .13 of AU-C section 530 establish requirements and provide guidance regarding sample design, size, and selection of items for testing and projecting the results of audit sampling, respectively. The definition of *audit sampling* is provided in paragraph .05 of AU-C section 530.

.48 The auditor should exercise professional judgment to determine whether audit sampling is appropriate. Sampling may not always be appropriate. For example, the auditor may decide that it is more efficient to test an account balance or class of transactions by applying analytical procedures.

.49 When an auditor plans any audit sampling application, the first consideration is the specific account balance or class of transactions and the circumstances in which the procedure is to be applied. The auditor will usually first identify items or groups of items that are of individual significance to an audit objective and relevant assertion. For example, an auditor planning to use audit sampling as part of the tests of an inventory balance, as well as observing the physical inventory, may identify items that have significantly large balances or that might have other special (risk) characteristics.

.50 The auditor should consider special knowledge about the items constituting the balance or class before designing audit sampling procedures. For example, the auditor might identify 20 items that make up 25 percent of the account balance, and decide that those items should be examined 100 percent and excluded from inventory subject to audit sampling. Any items that the auditor has decided to test 100 percent are not part of the population subject to sampling. This pre-segregation of significant items may also reduce the overall testing effort associated with the account balance or class of transactions.

.51 A population for audit sampling purposes does not necessarily need to be an entire account balance or class of transactions. In some circumstances, an auditor might examine all the items that constitute an account balance or class of transactions that exceed a given amount or that have an unusual characteristic; the auditor might either (*a*) apply other auditing procedures (for example, analytical procedures) to items that do not exceed a given amount or possess an unusual characteristic or (*b*) apply no auditing procedures to them because there are acceptably low risks of material misstatement existing in the remaining items.

.52 Once a decision has been made to use audit sampling, the auditor may choose between statistical and nonstatistical sampling. The choice is primarily a cost-benefit consideration. Statistical sampling uses the laws of probability to measure sampling risk. Any sampling procedure that does not measure the sampling risk is a nonstatistical sampling procedure.

.53 *Determining the test objectives*. A sampling plan for substantive tests of details might be designed to (*a*) test the reasonableness of one or more assertions about a financial statement amount (for example, the existence of accounts receivable) or (*b*) make an independent estimate of some amount (for example, the last in, first out [LIFO] index for a LIFO inventory). It is important that the auditor carefully identifies the characteristic of interest (for example, the misstatement) for the sampling application that is consistent with the audit objective.

.54 *Defining the population*. The population consists of the items constituting the account balance or class of transactions of interest subject to audit sampling. It is best practice for the auditor to determine at the beginning of the sampling application that the population from which he or she selects the sample is appropriate for the specific audit objective because sample results can be projected only to the population from which the sample was selected.

.55 *Defining the sampling unit*. A sampling unit is any of the individual elements that constitute the population, and depends on the audit objective and the nature of the audit procedures to be applied. A sampling unit might be a customer account balance, an individual transaction or an individual entry within a transaction. The auditor might consider which sampling unit leads to a more effective and efficient sampling application in the circumstances.

.56 *Choosing an audit sampling technique*. Either statistical or nonstatistical sampling is appropriate for substantive tests of details. The most common statistical approaches are classical variables sampling and monetary unit sampling.

.57 *Determining the method of selecting the sample*. The auditor should select the sample in such a way that the sample can be expected to be representative of the population or the stratum from which it is selected.

.58 *Determining the sample size*. Accounting populations tend to include few very large amounts, a number of moderately large amounts, and a large number of small amounts. Auditors frequently consider the variation in a characteristic when they determine an appropriate sample size for a substantive test of details, and, generally, the variation of the items' recorded amounts as a means of estimating the variation of the audited amounts of the items in the population. A measure of this variation, or scatter, is called the *standard deviation*. Sample sizes decrease as the variation of the sampling characteristic of interest becomes smaller. Sample sizes from unstratified populations with high variation in the sampling characteristic of interest are usually large. To be efficient, stratification is typically based on some characteristic of the items in the population that is expected to reduce variation.

.59 In performing substantive tests of details, auditors are also concerned with two aspects of sampling risk:

a. *Risk of incorrect acceptance*—the risk that the sample will lead the auditor to conclude that material misstatement does not exist in the population, when it does.

b. *Risk of incorrect rejection*—the risk that the sample will lead the auditor to conclude that material misstatement exists in the population, when it does not. This risk is generally controlled by setting an adequate or conservative estimate of expected misstatement and increasing the sample size accordingly.

.60 When planning a sample for a substantive test of details, the auditor typically considers how much monetary misstatement in the tested assertion may exist, when combined with misstatements that may be found in other tests in this and other accounts without causing the financial statements to be materially misstated. The auditor usually then designs the test to provide sufficient assurance that the population does not contain misstatements greater than this amount. The maximum monetary misstatement for the tested assertion is called tolerable misstatement for the sample. For a particular assertion, the sample size required to achieve the auditor's objective at a given risk of incorrect acceptance increases as the auditor's assessment of tolerable misstatement for that assertion decreases.

.61 The auditor is required by AU-C section 320 to determine performance materiality. Performance materiality is determined to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. *Tolerable misstatement* is the application of performance materiality to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount smaller than performance materiality (for example, when the population from which the sample is selected is smaller than the account balance). The factors that affect the relationship of performance materiality and tolerable misstatement to materiality are enumerated in the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* and discussed more extensively in chapter 4 of the Audit Guide *Audit Sampling*.

.62 The auditor also may assess the expected amount of misstatement on the basis of his or her professional judgment after considering such factors as the entity's business, the results of prior year's tests of account balances or class of transactions, the results of any pilot sample, the results of any related substantive procedures, and the results of any tests of the related controls.

.63 The effect of population size on the appropriate sample size varies according to the audit sampling method used.

.64 *Performing the sampling plan*. The auditor should perform auditing procedures that are appropriate for the particular audit objectives to each sample item.

.65 *Evaluating the sample results*. The following auditor actions are applicable when evaluating sample results:

- The auditor should project the results of audit sampling to the population and add that amount to the misstatements discovered in any items examined 100 percent.
- The auditor should propose factual misstatements to management for correction, unless the amounts are trivial.
- The auditor may compare the tolerable misstatement for the account balance or class of transactions with the total factual and projected misstatement, adjusted for any corrected misstatements. If the total factual and projected misstatement is less than tolerable misstatement for the account balance or class of transactions, the auditor should consider the risk that such a result might be obtained even though the true monetary misstatement for the population exceeds the tolerable misstatement. The factual and projected misstatement results for all audit sampling applications and all factual misstatements from nonsampling applications should be aggregated along with other relevant audit evidence when the auditor evaluates whether the financial statements as a whole may be materially misstated. AU-C section 450 establishes requirements and provides guidance for the auditor when evaluating the effect of uncorrected misstatements.
- The auditor should consider the qualitative aspects of misstatements. If the sample results suggest that the auditor's planning assumptions were in error, the auditor may consider revising the planning assumptions.

.66 *Documenting the sampling procedure*. AU-C section 530 and the AICPA Audit Guide *Audit Sampling* do not require specific documentation of audit sampling applications. See paragraph .17 of this section for certain documentation requirements of AU-C section 230.

.67 According to paragraph .12 of AU-C section 450, the auditor should include in the audit documentation

a. the amount below which misstatements would be regarded as clearly trivial;

b. all misstatements accumulated during the audit and whether they have been corrected; and

c. the auditor's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion.

.68 Examples of items that the auditor may document for substantive tests include the following:

- The objectives of the test the accounts and assertions affected
- The definition of the population and the sampling unit, including how the auditor determined the completeness of the population
- The definition of a misstatement
- The risk of incorrect acceptance or level of desired assurance (confidence)
- The risk of incorrect rejection, if used
- Estimated and tolerable misstatement
- The audit sampling technique used

- The method used to determine sample size
- The method of sample selection
- Identification of the items selected
- A description of the performance of the sampling procedures and a list of misstatements identified in the sample
- The evaluation of the sample (for example, projection and consideration of sampling risk)
- A summary of the overall sample conclusion (if not evident from the results)
- Any qualitative factors considered significant in making the sampling assessments and judgments

.69 Additional discussion on audit documentation is provided in section 5100, "Audit Evidence and Designing Further Audit Procedures."

.70 *Nonstatistical sampling for substantive tests of details*. The decision whether to use a statistical or nonstatistical sampling approach is a matter for the auditor's professional judgment; however, sample size is not a valid criterion to use in deciding between statistical and nonstatistical approaches. An auditor who applies nonstatistical sampling exercises professional judgment to relate the same factors used in statistical sampling in determining the appropriate sample size. Ordinarily, this would result in a sample size comparable with the sample size resulting from an efficient and effectively designed statistical sample, considering the same sampling parameters. This guidance does not suggest that the auditor using nonstatistical sampling also compute a corresponding sample size using an appropriate statistical technique.

.71 The following table, "Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning," summarizes the effects of various factors on sample sizes for substantive tests of details. (The table is provided only to illustrate the relative effect of different planning considerations on sample size and is not intended as a substitute for professional judgment).

Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning

	Conditions Leading to:		
Factor	*Smaller Sample Size*	*Larger Sample Size*	*Related Factor for Substantive Sample Planning*
a. Assessment of inherent risk	Low assessed level of inherent risk	High assessed level of inherent risk	Allowable risk of incorrect acceptance
b. Assessment of control risk	Low assessed level of control risk	High assessed level of control risk	Allowable risk of incorrect acceptance
c. Assessment of risk related to other substantive procedures directed at the same assertion (including substantive analytical procedures and other relevant substantive procedures)	Low assessment of risk associated with other relevant substantive procedures	High assessment of risk associated with other relevant substantive procedures	Allowable risk of incorrect acceptance
d. Measure of tolerable misstatement for a specific account	Larger measure of tolerable misstatement	Smaller measure of tolerable misstatement	Tolerable misstatement

	Conditions Leading to:		
Factor	*Smaller Sample Size*	*Larger Sample Size*	*Related Factor for Substantive Sample Planning*
e. Expected size and frequency of misstatements, or the estimated variance of the population	Smaller misstatements or lower frequency, or smaller population variance	Larger misstatements, higher frequency, or larger population variance	Assessment of population characteristics
f. Number of items in the population	Virtually no effect on sample size unless population is very small		

.72 For additional details on audit sampling, including detailed tables, auditors may refer to AICPA Audit Guide *Audit Sampling*.

.73 Stratification is particularly important to increasing the efficiency of the sample. If the nonstatistical sample design is planned without stratification, the auditor increases the sample size. The extent of increase is a function of the variability of the population or the characteristic of interest. Before selecting the sample, the auditor generally identifies individually significant items and may then select the sample from the remaining items using a proportional to size selection technique (for example, a systematic selection based on every n^{th} dollar, which automatically stratifies the sample), or stratify the remaining items into groups and allocate the sample size accordingly.

.74 *Evaluating the sample results*. The results of the audit sampling should be projected to the population. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement in the sample by the fraction of total dollars in the population included in the sample. For example, if a $100 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $1,000 ($100 ÷ .10).

.75 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 5,000 items) by the average difference of $2 for each sample item. The estimate of misstatement in the population is $10,000 (5,000 × 2). An auditor nonstatistically emulating a monetary unit sampling application may use a projection method consistent with that technique.

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AAM Section 5500

Suggested Supplemental Reference Materials

.01 The following publications are useful in helping to determine the nature, timing, and extent of audit procedures. To order AICPA products, call 888.777.7077 or go to www.cpa2biz.com to order products online.

- **Audit and Accounting Guides (AICPA)**

  Each guide describes relevant matters, conditions, and procedures unique to a particular industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.

- **Audit Risk Alerts (AICPA)**

  Audit Risk Alerts complement the guidance provided in many of the Audit and Accounting Guides by describing current economic, regulatory, and professional developments that can have a significant impact on engagements.

- **Financial Reporting Alerts (AICPA)**

  Financial Reporting Alerts are useful for members of an entity's financial management, board members, and audit committee to identify and understand current accounting and regulatory developments affecting the entity's financial reporting.

- **Professional Standards (AICPA)**

  The publication features the outstanding pronouncements on professional standards issued by the AICPA, including standards for audits, compilations, and reviews.

- **Disclosure Checklist Series (AICPA)**

  The practice aids are invaluable to anyone who prepares financial statements and reports. The material has been updated to reflect AICPA, FASB, and GASB pronouncements and interpretations as well as SEC regulations.

- **The Engagement Letter: Best Practices and Examples (AICPA)**

  This online tool provides guidance on developing engagement letters in accordance with applicable AICPA Professional Standards*, supplemented with best practice recommendations to ensure the engagement letter is as effective as possible in clearly documenting the terms of the engagement. Illustrative examples are provided throughout all chapters so practitioners can easily apply the requirements and recommendations for auditing, compilation, review, and certain attestation engagements. Offered in a convenient and efficient online format, subscribers to this online tool can download the sample engagement letters for easy mark up and customization.*

- **The Auditor's Report: Comprehensive Guidance and Examples (AICPA)**

  This online tool provides expert guidance on developing the auditor's report in accordance with applicable AICPA Professional Standards*, including the new clarified auditing standards. Offered in a convenient and efficient online format, subscribers to this online tool can download the sample auditor's reports for easy mark up and customization.*

- **Audit Risk Assessment Tool and Guide (AICPA)**

  This tool walks an experienced auditor through risk assessment procedures and documents those decisions necessary to prepare an effective, efficient audit program. Designed to be used in lieu of cumbersome checklists, it provides a top down risk-based approach to the identification of high risk areas, allowing *appropriate tailoring of audit programs and audit efficiencies. Includes the Audit Guide* Assessing and Responding to Audit Risk in a Financial Statement Audit*.*

- **U.S. GAAP Financial Statements: Best Practices in Presentation and Disclosure (AICPA)**

  This publication contains reporting methods based on a cumulative survey, as well as significant accounting presentations and discussions, of accounting principles generally accepted in the United States. By following the lead of these industry front-runners, practitioners can apply the latest techniques and improve their own reporting performance. Additional versions of this publication are also available for preparers of financial statements for not-for-profit entities, international companies that are using International Financial Reporting Standards, and employee benefit plans.

- **Technical Practice Aids (AICPA)**

  This publication contains all outstanding AICPA Auditing and Attestation Statements of Position and Practice Alerts; Technical Questions and Answers issued by the AICPA on a variety of accounting, auditing, and industry topics; implementation guidance issued by the staff of the Public Company Accounting Oversight Board; and Trust Services Principles, Criteria, and Illustrations; and offers carefully thought-out responses to selected inquiries received by the AICPA Technical Hotline and AICPA Technical and Industry Committees.

- **Standard Form to Confirm Account Balance Information with Financial Institutions (AICPA)**

  This form may be used to request a full report on credit balance, liabilities, and contingent liabilities. It may also be used for a confirmation of bank balance only.

- **Accountants' Handbook by Carmichael, Lilien & Mellman (Wiley)**
- **Montgomery's Auditing by O'Reilly, Hirsch, Defliese, and Jaenicke (Wiley)**
- **Handbook of Modern Accounting by Davidson & Weil (McGraw-Hill)**
- **Kohler's Dictionary for Accountants by Coopers & Ijiri (Prentice-Hall)**

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AAM Section 6000
Audit Documentation

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AAM Section 6100

Audit Documentation—General

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 230, *Audit Documentation*
- AU-C section 610A, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*

QC Section:

- QC section 10, *A Firm's System of Quality Control*

Nature and Purpose of Audit Documentation

.01 *Audit documentation* is defined as the record of audit procedures performed, relevant audit evidence obtained, and conclusions reached by the auditor in the engagement. Audit documentation may also be referred to as *working papers* or *workpapers*. Audit documentation that meets the requirements of AU-C section 230 and the specific documentation requirements of other relevant AU-C sections provides

- evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
- evidence that the audit was planned and performed in accordance with generally accepted auditing standards (GAAS) and applicable legal and regulatory requirements.

.02 Audit documentation serves a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work and to discharge their review responsibilities in accordance with AU-C section 220
- Enabling the engagement team to demonstrate that it is accountable for its work by documenting the procedures performed, the audit evidence examined, and the conclusions reached
- Retaining a record of matters of continuing significance to future audits of the same entity
- Enabling the conduct of quality control reviews and inspections in accordance with QC section 10
- Enabling the conduct of external inspections or peer reviews in accordance with applicable legal, regulatory, or other requirements
- Assisting an auditor who reviews a predecessor auditor's audit documentation
- Assisting auditors to understand the work performed in the prior year as an aid in planning and performing the current engagement

.03 AU-C section 230 establishes standards and provides guidance on the form, general content, and ownership and confidentiality of audit documentation.

.04 Other AU-C sections that contain specific documentation requirements and can be found in the exhibit at the end of AU-C section 230. Additionally, specific documentation or document retention requirements may be included in other standards (for example, government auditing standards), laws, and regulations applicable to the engagement.

Timely Preparation of Audit Documentation

.05 The auditor should prepare audit documentation on a timely basis. Preparing sufficient and appropriate audit documentation on a timely basis throughout the audit helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared at the time such work is performed or shortly thereafter is likely to be more accurate than documentation prepared at a much later time.

Assembly and Retention of the Final Audit Engagement File

.06 The auditor should document the report release date in the audit documentation.

.07 The auditor should assemble the audit documentation in an audit engagement file and complete the administrative process of assembling the final audit engagement file on a timely basis, no later than 60 days following the report release date (also known as the *documentation completion date*). The auditor may need to consider that statutes, regulations, or the audit firm's quality control policies could specify a period of time shorter than 60 days following the report release date in which this assembly process is to be completed. Certain matters, such as auditor independence and staff training, which are not engagement specific, may be documented either centrally within a firm or in the audit documentation for an audit engagement.

.08 The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include

- deleting or discarding superseded documentation.
- sorting, collating, and cross-referencing working papers.
- signing off on completion checklists relating to the file assembly process.
- documenting audit evidence that the auditor has obtained, discussed, and agreed with the relevant members of the engagement team before the date of the auditor's report.
- adding information received after the date of the auditor's report; for example, an original confirmation that was previously faxed.

.09 After the documentation completion date, the auditor should not delete or discard audit documentation of any nature before the end of the specified retention period. Such retention period, however, should not be shorter than five years from the report release date.

.10 Firms are required by paragraph .50 of QC section 10 to establish policies and procedures for the retention of engagement documentation. Statutes, regulations, or the audit firm's quality control policies may specify a retention period longer than five years.

.11 In circumstances other than those addressed in paragraph .14 of AU-C section 230 in which the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the documentation completion date, the auditor should, regardless of the nature of the modifications or additions, document

a. the specific reasons for making the changes; and

b. when and by whom they were made and reviewed.

.12 An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after the documentation completion date is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

.13 Determining the proper periods for retaining records is a major decision for practitioners. Records may be preserved for only as long as they serve a useful purpose or until all legal requirements are met. Record retention periods vary among firms; however, retention periods generally correspond with the longest statute of limitations prevailing in each state for breach of contract, breach of fiduciary duty, and professional liability claims.

.14 Audit documentation may be retained permanently or for periods corresponding with the longest state statute of limitations, as noted in the previous paragraph. Generally, certain audited financial statement working paper data, such as accounts receivable confirmations, are destroyed after 10 years. Examples of audit documentation that the auditor may wish to retain permanently include auditor's reports, reports filed with the Securities and Exchange Commission, tax returns for current clients, and audit documentation for current clients. Some firms divide the retention period into 2 parts, records are first filed in the office and later placed in storage (for example, 3 years in the office and then permanently in storage). Other records, such as audit documentation files for former clients, may be retained for 3 years in the office, 7 years in storage, and then destroyed after the retention period has ended. The auditor may obtain specific approval of the engagement partner before destroying any audit documentation. An annual schedule may be established for reviewing and purging firm data. Because there is substantial variation in the retention periods used by firms, each firm may carefully consider its requirements and consult with legal counsel before adopting a retention period.

.15 For further guidance on record retention, see the AICPA *Management of an Accounting Practice Handbook* (online subscription product no. MAP-XX) at www.cpa2biz.com. This product can also be obtained by calling the AICPA order department at 888.777.7077 and asking for product no. MAP-XX (online) or product no. 090407 (loose-leaf).

Departure From a Relevant Requirement

.16 If, in rare circumstances, the auditor judges it necessary to depart from a relevant presumptively mandatory requirement, the auditor must document the justification for the departure and how the alternative audit procedures performed in the circumstances were sufficient to achieve the intent of that requirement.

.17 The requirements of GAAS are designed to enable the auditor to achieve the objectives specified in GAAS, and thereby the overall objectives of the auditor. Accordingly, other than in rare circumstances, GAAS call for compliance with each requirement that is relevant in the circumstances of the audit.

.18 The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant only in the cases in which

- the AU-C section is not relevant (for example, if an entity does not have an internal audit function, nothing in AU-C section 610A is relevant); or
- the requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion when there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

Matters Arising After the Date of the Auditor's Report

.19 If, in rare circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor should document

a. the circumstances encountered;

b. the new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

c. when and by whom the resulting changes to audit documentation were made and reviewed.

.20 Examples of rare circumstances in which the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report include

- when, after the date of the auditor's report, the auditor becomes aware of facts that existed at that date and which, if known at that date, might have caused the financial statements to be revised or the auditor to modify the opinion in the auditor's report.
- when the auditor concludes that procedures necessary at the time of the audit, in the circumstances then existing, were omitted from the audit of the financial information.

The resulting changes to the audit documentation are reviewed in accordance with the firm's quality control procedures as required by QC section 10.

Ownership and Confidentiality of Audit Documentation

.21 Audit documentation is the property of the auditor, and some states recognize this right of ownership in their statutes. The auditor may make available to the entity at the auditor's discretion copies of the audit documentation, provided such disclosure does not undermine the effectiveness and integrity of the audit process.

.22 The auditor has an ethical, and in some situations a legal, obligation to maintain the confidentiality of client information. Because audit documentation contains confidential client information, the auditor should adopt reasonable procedures to maintain the confidentiality of that information.

.23 The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.

.24 Whether engagement documentation is in paper, electronic, or other media, the integrity, accessibility, or retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the auditor's knowledge or if it could be permanently lost or damaged. Accordingly, controls that the firm designs and implements to avoid unauthorized alteration or loss of engagement documentation may include those that

- enable the determination of when and by whom engagement documentation was prepared or reviewed;
- protect the integrity of the information at all stages of the audit, especially when the information is shared within the engagement team or transmitted to other parties via electronic means;
- prevent unauthorized changes to the engagement documentation; and
- allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

General Discussion

.25 These sections present points of view on the organization and preparation of audit documentation.

.26 Proper planning is important in the design of specific audit documentation if the documentation is to serve the objective of aiding the auditor in the conduct of his or her work. For example, a well-planned working paper may be designed to provide information that will be needed later in the preparation of tax returns and other required reports, such as those to regulatory bodies, and may therefore eliminate the need for examining the same documents twice to obtain necessary information. The form, content, and extent of audit documentation are matters of the auditor's professional judgment and depend on the circumstances of the engagement and the audit methodology and tools used. The individual preferences of auditors and firms may be informal common practices or expressed as part of a firm's formal policies and procedures. A firm may consider the nature of its practice and the services commonly provided to its clients, in addition to professional standards, in developing its procedures and policies on audit documentation. Those procedures and policies may permit the flexibility necessary to meet the needs of individual engagements.

[*The next page is 6201.*]

AAM Section 6200

Form, Content, and Extent of Audit Documentation

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 230, *Audit Documentation*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

QC Section:

- QC section 10, *A Firm's System of Quality Control*

.01 The form, content, and extent of audit documentation vary with the circumstances and needs of the auditors on individual engagements. Some firms, however, include various general and specific instructions on audit documentation content in their policies concerning the working papers.

.02 Examples of audit documentation are audit programs, analyses, issues, memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail), and schedules or commentaries prepared or obtained by the auditor. Abstracts or copies of the entity's records should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. Audit documentation may be in paper form, electronic form, or other media.

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content, and Extent of Audit Documentation

.03 The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection to the audit, to understand

a. the nature, timing, and extent of the auditing procedures performed to comply with GAAS and applicable legal and regulatory requirements, including

   i. the identifying characteristics of the specific items or matters tested (for example, tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation);

   ii. who performed the audit work and the date such work was completed; and

   iii. who reviewed the audit work performed and the date of such review.

b. the results of the audit procedures performed and the audit evidence obtained.

c. significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

.04 For audit procedures related to the inspection of significant contracts or agreements, the auditor should include abstracts or copies of those contracts or agreements in the audit documentation.

.05 The auditor should document discussions of significant findings or issues with management, those charged with governance, and others, including the nature of the significant findings or issues discussed, and when and with whom the discussions took place.

.06 If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant finding or issue, the auditor should document how the auditor addressed the inconsistency.

Documentation of Compliance With GAAS

.07 In principle, compliance with the requirements of this section will result in the audit documentation being sufficient and appropriate in the circumstances. Other AU-C sections contain specific documentation requirements that are intended to clarify the application of this section in the particular circumstances of those other AU-C sections. The specific documentation requirements of other AU-C sections do not limit the application of this section. Furthermore, the absence of a documentation requirement in any particular AU-C section is not intended to suggest that there is no documentation that will be prepared as a result of complying with that AU-C section.

.08 Audit documentation provides evidence that the audit complies with GAAS. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. See the following examples:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed to the terms of the audit engagement with management or, when appropriate, those charged with governance.
- An auditor's report containing an appropriately qualified opinion on the financial statements demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances in accordance with GAAS.
- Regarding requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
  — For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with GAAS. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.
  — Similarly, that the engagement partner has taken responsibility for the direction, supervision, and performance of the audit in compliance with GAAS may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussions required by AU-C section 315.

Factors Affecting the Form, Content, and Extent of Audit Documentation

.09 The form, content, and extent of audit documentation depend on factors such as

- the size and complexity of the entity.
- the nature of the auditing procedures to be performed.

- the identified risks of material misstatement.
- the significance of the audit evidence obtained.
- the nature and extent of exceptions identified.
- the need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or evidence obtained.
- the audit methodology and tools used.
- the extent of judgment involved in performing the work and evaluating the results.

.10 Audit documentation may be recorded on paper or on electronic or other media. QC section 10 addresses a firm's responsibility to establish procedures designed to maintain the integrity, accessibility, and retrievability of documentation; for example, when original paper documentation is electronically scanned or otherwise copied to another media for inclusion in the audit file. Examples of audit documentation include the following:

- Audit plans
- Analyses
- Issues memorandums
- Summaries of significant findings or issues
- Letters of confirmation and representation
- Checklists
- Correspondence (including e-mail) concerning significant findings or issues

.11 The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

.12 On their own, oral explanations by the auditor do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

Documentation of Significant Findings or Issues and Related Significant Professional Judgments

.13 Judging the significance of a finding or issue requires an objective analysis of the facts and circumstances. Examples of significant findings or issues include

- matters involving the selection, application, and consistency of significant accounting practices, including related disclosures. Such matters include, but are not limited to (*a*) accounting for complex or unusual transactions or (*b*) accounting estimates and uncertainties and, if applicable, the related management assumptions.
- matters that give rise to significant risks (as defined in AU-C section 315).
- results of audit procedures (including identification of corrected and uncorrected misstatements) indicating (*a*) that the financial statements could be materially misstated or (*b*) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- findings that could result in a modification to the audit opinion or the inclusion of an emphasis-of-matter paragraph in the auditor's report.

.14 An important factor in determining the form, content, and extent of audit documentation of significant findings or issues is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, when significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such findings or issues are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits when reviewing items of continuing significance (for example, when performing a retrospective review of accounting estimates).

.15 Some examples of circumstances in which, in accordance with paragraph .08, it is appropriate to prepare audit documentation relating to the exercise of professional judgment include, when the findings, issues, and judgments are significant,

- the rationale for the auditor's conclusion when a requirement provides that the auditor *should consider* certain information or factors, and that consideration is significant in the context of the particular engagement.
- the basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- the basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of a specialist or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

.16 The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant findings or issues identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant findings or issues. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant AU-C section objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Identification of Specific Items or Matters Tested and of the Preparer and the Reviewer

.17 Recording the identifying characteristics serves a number of purposes. For example, it improves the ability of the auditor to supervise and review the work performed and thus demonstrates the accountability of the engagement team for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:

- For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register for the period being audited).
- For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point, and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period from April 1 to September 30, starting with report number 12345 and selecting every 125th report).
- For a procedure requiring inquiries of specific entity personnel, the auditor may record the inquiries made, the dates of the inquiries, and the names and job designations of the entity personnel.

- For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

.18 AU-C section 220 requires the auditor to review the audit work performed through review of the audit documentation. The requirement to document who reviewed the audit work performed and the extent of the review, in accordance with the firm's policies and procedures addressing review responsibilities, does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

Documentation of Discussions of Significant Findings or Issues With Management, Those Charged With Governance, and Others

.19 The audit documentation is not limited to documents prepared by the auditor but may include other appropriate documents such as minutes of meetings prepared by the entity's personnel and recognized by the auditor as an appropriate summary of the meeting. Others with whom the auditor may discuss significant findings or issues may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

Documentation of How Inconsistencies Have Been Addressed

.20 The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

.21 The documentation of the inconsistency may include, but is not limited to, procedures performed in response to the information, and documentation of consultations on, or resolutions of, differences in professional judgment among members of the engagement team or between the engagement team and others consulted.

Considerations Specific to Smaller, Less Complex Entities

.22 The audit documentation for the audit of a smaller, less complex entity is generally less extensive than that for the audit of a larger, more complex entity. Further, in the case of an audit in which the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team (for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement in paragraph .08 of AU-C section 230 to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.

.23 When preparing audit documentation, the auditor of a smaller, less complex entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller, less complex entity include the understanding of the entity and its internal control; the overall audit strategy and audit plan; materiality; assessed risks, significant findings or issues noted during the audit; and conclusions reached.

Basic Elements of Format

.24 Audit documentation formats generally include at least the following for identification purposes:

- A title or heading including (*a*) the name of the client, (*b*) a caption that briefly describes the paper's contents, (*c*) the nature of the engagement, and (*d*) the applicable period or closing date covered by the engagement

- The initials or names of the auditors who performed and reviewed the work presented in the paper and the date the paper was completed

.25 In instances when audit documentation extends beyond 1 page, some auditors present the heading on only the lead page and fasten or staple all the applicable pages together as a unit and number each page (for example, 1 of 5, 2 of 5, and so forth). Many auditors index each working paper in some organized pre-established manner. This provides for ease in cross-referencing to other relevant papers, for more organized indexing and filing, and for a form of control over the audit documentation. (See section 6300, "Organization and Filing (Indexing).")

.26 Some auditors purchase standard analysis paper that includes preprinted blocks for the initials or signature of the preparer and reviewer and the dates on which the paper was prepared and reviewed. Others design their own signature and reference blocks and have them imprinted on all of their analysis paper and lined pads. These signature blocks may include captions such as the following:

• Prepared by client and tested by: (or Source:)	• Audit documentation reference:
• Prepared by:	• Reviewed by:
• Date prepared:	• Date reviewed:
• Footed by:	• Extensions checked by:

.27 Some auditors prefer to identify client preparation of schedules and analysis by notations or codes, such as PBC (prepared by client), rather than use a detailed signature and reference block.

General Considerations

.28 The following are some general considerations on audit documentation content that may be helpful:

- The auditor may include identification of the (*a*) source of the information presented (for example, fixed assets ledger or cash disbursements journal), (*b*) the nature and extent of the work done and conclusions reached (by symbols and legend, narrative, or a combination of both), and (*c*) appropriate cross-references to other working papers in the content of an individual working paper or group of related papers.
- The auditor should document significant findings or issues, actions taken to address them, and the basis for the final conclusions reached. If for some reason the auditor leaves the assignment before resolving all items, he or she may provide an open items listing on a separate temporary paper for the in-charge auditor's attention. An unresolved exception or incomplete explanation in the working papers may be construed by some as indication of an inadequate audit.
- Information and comments in the audit documentation generally represent statements of fact and professional conclusions. Accordingly, the auditor may wish to refrain from using vague judgmental adjectives such as *good* or *bad*. Conclusions should be supported by documented facts, especially if they concern the adequacy of the client's records.
- Working papers are an integrated presentation of information. The auditor may find it useful to cross-reference working papers to call attention to inter-account relationships and to reference a paper to other working papers summarizing or detailing related information.
- All inferences and conclusions should be supported in the working papers, and due care taken not to make misleading or irrelevant statements.
- It is preferable to have negative figures in audit documentation indicated by parentheses instead of red figures to preserve their identity if the papers are photocopied or scanned.

Timesaving Considerations

.29 There are a number of ways to save time and avoid unnecessary detail in audit documentation preparation. For example, the auditor may consider the following examples:

- Whenever possible, have the client's employees prepare schedules and analyses. This, of course, presupposes that the client has the necessary personnel to prepare the materials.
- Use a detailed audit program that may eliminate the need for lengthy comments in the audit documentation on the scope of audit procedures. However, some believe that such comments are still necessary when a detailed program is used; this is a matter of individual firm judgment.
- Analyze asset (or liability) accounts and their related expense or income accounts on the same working paper. Examples include property, plant, and equipment, accumulated depreciation, and related depreciation expense; notes receivable, accrued or prepaid interest receivable, and interest income; notes payable, accrued or prepaid interest, and interest expense; and accrued taxes and related provisions for tax expense.
- Avoid unnecessary computations. For example, if only the totals are meaningful and can be tested by a single independent computation, check the total and avoid other unnecessary details.
- Consider using carryforward analyses for accounts that tend to remain constant each year or vary only in accordance with a constant predetermined formula. Examples may include long term assets and related depreciation or amortization such as plant, equipment, and intangibles; long term debt with predetermined payment schedules; and capital stock.
- Use symbols (tick marks) whenever possible, especially when the same symbol applies to several working papers.

Symbols (Tick Marks)

.30 When using symbols, it may be helpful to consider the following basic concepts:

- Symbols are merely a shorthand means of explaining a work step performed on a particular item of data. Symbols serve as means of conserving time and space and, if properly used, may ease review of the audit documentation.
- For a working paper to be clear to a reviewer or other reader, it is important that each symbol be clearly explained. The explanation may be located on the same page as the items subjected to the work step or on a separate legend that is clearly cross-referenced to and from the page that presents the applicable items.
- Simple, distinctive, and clear symbols can be quickly written by the preparer and easily identified by a reviewer.

.31 Applying these basic concepts is not that simple. Various auditors have conflicting notions about symbols. For example, some believe a set of standardized symbols can expedite preparation and review. Others believe that a set of standardized symbols is impractical because it lacks flexibility. Because it is generally agreed that symbols are an effective timesaver, it is desirable for firms to establish and communicate a policy on their use to maximize their potential effectiveness.

.32 The most commonly used symbols are variations on a simple checkmark—for example, a checkmark with a slash, a checkmark with a circle at the end, a double checkmark, and any one of these within a circle. These combinations alone provide eight distinctive tick marks. Symbols may also include circled letters or numbers.

[*The next page is 6301.*]

AAM Section 6300

Organization and Filing (Indexing)

This section contains the following reference from AICPA *Professional Standards*:

AU-C Section:

- AU-C section 230, *Audit Documentation*

.01 Some auditors organize their audit documentation during the course of an engagement into general categories such as the following:

- Planning and administration
- Internal control understanding and assessment of control risk
- Substantive test audit documentation arranged in order of the balance sheet and income statement classifications
- Trial balances, consolidating working papers, journal entries (adjustments, reclassifications, eliminations for consolidation), and potential entries
- Draft reports, financial statements, and notes
- Programs, checklists, and questionnaires (some keep these as separate units, and others interfile them among working papers by statement classifications)
- General matters such as current minutes, contracts, and articles of incorporation that may apply to future engagements as well as current work

Under this approach, actual indexing and filing may be deferred until the conclusion of the engagement.

Predetermined Indexing

.02 Other practitioners and firms may use a predetermined indexing approach so that working papers can be indexed while the field work is still in progress. This offers the following advantages:

- Better control over audit documentation during the performance of field work
- Constant arrangement of audit documentation in logical order to aid in review
- Less time required in assembling and filing them into indexed files
- Quicker access to specific audit documentation after it is filed

.03 Predetermined indexing involves establishing a standard code for each section of the audit documentation using letters and numbers or numbers only. See the following table for an example.

	Two Possible Alternatives	
Working trial balance—assets	B/S-A	T/B-1
Working trial balance—liabilities	B/S-L	T/B-2
Working trial balance—income and expense	P/L	T/B-3
Cash summary schedule	A	10
Receivables summary schedule	B	20
Inventory summary schedule	C	30

.04 Predetermined indexing requires recognition of the need for flexibility to meet unanticipated audit documentation needs or specialized industry requirements, and it requires care to avoid undue complexity. Excessively complex references may obstruct rather than ease audit documentation preparation, cross-referencing, and filing. Accordingly, it is helpful to develop an organizational plan adaptable to each section of the audit documentation. For example, some accountants classify working papers as lead schedules, primary detail, and secondary detail that might result in the following classification scheme for the preceding examples for cash.

	Using Letters and Numbers	*Using Only Numbers*
Lead schedule	(A)	(10)
Primary detail schedules	(A-1) (A-2) and so forth	(10-1) (10-2) and so forth
Secondary detail schedules	(A-1-1) (A-1-2) (A-1-3)	(10-1-1) (10-1-2)
	(A-2-1) (A-2-2) (A-2-3)	(10-2-1) (10-2-2)

.05 Predetermined (standardized) indexing systems may be printed on separate pages for reference during the performance of field work and insertion in the front of audit documentation binders or files when the work is completed. Some firms have their uniform indexing systems printed directly on their file or binder covers.

.06 A well-organized indexing system need not be too complex. On a fairly small engagement, the indexing system may be a lead schedule divider tab between each major group of accounts with the name of the account on it (for example, cash or accounts receivable) with the related working papers filed behind the lead schedule without being individually indexed. At the completion of the engagement, the pages can be consecutively numbered within each account group (for example, 1 of 10, 2 of 10, and so forth). Because there typically are not numerous or complex layers of supporting schedules, extensive cross-referencing can be avoided.

.07 On large engagements, particularly those with detailed charts of accounts, firms may consider it necessary to develop more complex indexing systems. In one such system, standard index number series are assigned as follows:

Current audit documentation	1000–7000
Permanent file	7100–9999

.08 In this system, each index number has 4 digits, with the addition of decimals if necessary. Numbers ending with double zero are reserved for lead schedules whose total agrees with a line item on the working trial balance (index 1400). Single zeros are used for specific types of accounts (such as 2010, petty cash funds).

.09 Certain index numbers can be permanently assigned to each major financial statement classification. For instance, index 2000 may be assigned to cash. If various bank accounts exist, the cash schedules are assigned index numbers 2002, 2003, and so forth. Documentation, such as supporting confirmations and lists of outstanding checks, would be assigned index numbers commencing with 2001.1, 2001.2, and so forth. As for the permanent audit documentation file, index 9300, for example, may be assigned to internal control. Accordingly, flowcharts and related questionnaires would be assigned index numbers in that series.

Current and Permanent Files

.10 Audit documentation files are generally classified as current files and permanent (continuing) files. Current files contain information that is pertinent to a single engagement. Permanent files include information relevant to several recurring engagements. Some firms have their binder or file covers preprinted as current or permanent accompanied by pertinent portions of their uniform audit documentation indexes.

.11 A common challenge to many auditors is to keep the permanent file complete, current, and free from outdated or irrelevant materials that belong in an inactive file of superseded materials.

.12 Some auditors who have confronted many unwieldy permanent files believe that it is better to classify all audit documentation as current with certain materials designated as matters of continuing interest to be carried forward each year until they become outdated. Under this approach, a firm may preprint its complete index on one type of file or binder cover and provide space to indicate whether specific contents are continuing or carry forward in nature. Regardless of the approach used, it is important to recognize that the provisions of AU-C section 230 apply to current year audit documentation maintained in *any* type of file (this includes permanent files) if such documentation serves as support for the current year's audit report.

.13 The requirements and guidance in AU-C section 230 also apply to permanent files. Accordingly, permanent files should be reviewed and updated, as needed, in conjunction with the annual audit. Examples of documents that may be found in permanent files are listed in paragraph .14 of section 6100, "Audit Documentation—General."

Observations and Suggestions

The audit documentation files should contain copies of final executed documents when needed to enable an experienced auditor to understand the work performed and conclusions reached. Any drafts or unsigned versions of documents should be replaced with final versions.

Index Topics

.14 The following is a list of topics to consider in developing a standard index for audit documentation. This list is detailed, but it is by no means all inclusive. For example, specialized industries such as life insurance and banking need other specialized topics. Several of the topics may be eliminated, condensed, or expanded depending on the auditor's needs and preferences:

Planning and administration

- Time and budget data
- General correspondence and memos
- Memos—current
- Notes and copies for use in next engagement
- Engagement letters
- Schedules and analyses to be prepared by client
- Minutes
- Checklist of an administrative nature if required by firm policy

Audit or work program[1]

Matters of continuing concern

- Client's industry—background
- Description and brief history of client
- Data and ratio analysis of client's operations
- Client's facilities

[1] Alternate practices of filing audit programs include

- putting the program in a binder that is separate and distinct from current and permanent files;
- putting the signed-off program in the current file; and
- keeping a master copy of the program in the permanent file with the signed off copies dispersed among the related audit documentation segments in the current file.

- Articles of incorporation
- Bylaws
- Current contracts and agreements
  - Debt agreements
  - Leases
  - Labor contracts
  - Agreements with officers and key people
  - Pension plans
  - Profit-sharing plans
  - Stock warrants
  - Stock options
  - Other agreements
  - Client's accounting policies and procedures
  - Carryforward analyses[2]

Internal control

- Internal control questionnaire, narrative, flowcharts, and so forth[3]
- Initial assessment of control risk memos
- Tests of controls

Reports, financial statements and footnotes, trial balances, and assembly sheets

- Reports and financial statements (including letters, if any, on reportable conditions in internal control)
- Consolidating working papers
- Consolidation eliminating entries
- Trial balance
- Adjusting journal entries
- Reclassification journal entries
- Recap of possible adjusting entries
- Assembly sheets supporting footnote disclosures (if the information is not included elsewhere in the audit documentation)
- Disclosure checklists (if required by firm policy)
- Supporting schedules (if required for reports to regulatory bodies or other reports)
- Tax return information and work sheets[4]

[2] Certain classifications may lend themselves to carry-forward audit documentation. Examples include allowances for doubtful accounts, brief summaries of confirmation response statistics, accumulated depreciation and amortization, deferred income taxes and open tax positions, long term debt, and capital accounts. Carry-forward audit documentation depends on the auditor's professional judgment and the nature of the specific account.

[3] Internal control questionnaires may be filed as separate binders or as part of current of permanent files.

[4] Some firms and practitioners keep tax return preparation working papers in files that are completely separate from other types of engagement working papers.

Assets

- Cash
- Marketable securities (and related income)
- Notes receivable (and related interest)
- Accounts receivable
  - — Summary and analyses
  - — Confirmation procedures[5, 6]
- Allowance for doubtful accounts and notes[7]
- Inventories
  - — Summary and analysis
  - — Price tests, cost, and market
  - — Obsolescence review
  - — Observation, test counts, and cutoff data
  - — Last in, first out determinations
- Prepaid expenses
- Other current assets
- Investments
- Property, plant and accumulated depreciation, and depletion and amortization[8]
- Intangible deferred charges and amortization[9]
- Other assets
- Intercompany accounts

Liabilities

- Notes payable (and related interest)
- Accounts payable
- Accrued liabilities other than income taxes
- Accrued income taxes (both current and deferred), related provisions, and credits[10]
  - — Federal
  - — State and local
- Other current liabilities
- Long-term debt (including current maturities and capitalized leases)[11]

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[5] See footnote 2.

[6] For situations involving voluminous responses or bulk inventory listings, the bulk materials may be filed in separate binders that are cross referenced to the pertinent audit documentation (for example, accounts receivable, accounts payable, and inventory).

[7] See footnote 2.

[8] See footnote 2.

[9] See footnote 2.

[10] See footnote 2.

[11] See footnote 2.

- Other long-term liabilities
- Deferred income[12]

Commitments and contingencies

- Attorney's letters
- Abstractors of commitments and contingencies noted during review of minutes, contracts and agreements, confirmation responses, and so forth
- Subsequent events review
- Management representation letter

Equity (capital accounts)[13]

- Capital stock
- Additional paid-in capital
- Treasury stock
- Retained earnings
- Partnership capital

Revenue and expenses

- Operating revenues
- Cost of sales
- Selling, general and administrative
- Other operating expenses
- Other income
- Other expense
- Extraordinary and unusual items
- Secondary schedules
  - — Maintenance and repairs
  - — Taxes other than income taxes
  - — Rents
  - — Royalties
  - — Advertising costs
  - — Legal fees
  - — Interest expense recap

[*The next page is 7001.*]

[12] See footnote 2.
[13] See footnote 2.

AAM Section 7000

Correspondence, External Confirmations, and Written Representations

These samples are presented for illustrative purposes only. They are intended as mere conveniences for users of this manual who may want points of departure when designing their own formats to meet their individual needs. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants are to rely on profes sional standards and their individual professional judgment in determining what may be needed in the circumstances.

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[*The next page is 7101.*]

AAM Section 7100

External Confirmations and Correspondence

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 260, *The Auditor's Communication With Those Charged With Governance*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- AU-C section 500, *Audit Evidence*
- AU-C section 505, *External Confirmations*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

External Confirmation Procedures

.01 *External confirmation* is defined by paragraph .06 of AU-C section 505 as audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), either in paper form or by electronic or other medium (for example, through the auditor's direct access to information held by a third party).

.02 The auditor's direct access to information held by a third party (the confirming party) may meet the definition of an *external confirmation* when, for example, the auditor is provided by the confirming party with the electronic access codes or information necessary to access a secure website where data that addresses the subject matter of the confirmation is held. The auditor's access to information held by the confirming party may also be facilitated by a third-party service provider. When access codes or information necessary to access the confirming party's data is provided to the auditor by management, evidence obtained by the auditor from access to such information does not meet the definition of an *external confirmation*.

.03 When using external confirmation procedures, the auditor should maintain control over external confirmation requests, including

a. determining the information to be confirmed or requested;

b. selecting the appropriate confirming party;

c. designing the confirmation requests, including determining that requests are properly directed to the appropriate confirming party and provide for being responded to directly to the auditor; and

d. sending the requests, including follow-up requests, when applicable, to the confirming party.

Determining the Information to Be Confirmed or Requested

.04 External confirmation procedures frequently are performed to confirm or request information regarding account balances, elements thereof, and disclosures. They also may be used to confirm the terms of agreements, contracts, or transactions between an entity and other parties or to confirm the absence of certain conditions, such as a "side agreement."

Selecting the Appropriate Confirming Party

.05 Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party who the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

Designing Confirmation Requests

.06 The design of a confirmation request may directly affect the confirmation response rate and the reliability and nature of the audit evidence obtained from responses.

.07 Factors to consider when designing confirmation requests include the following:

- The assertions being addressed.
- Specific identified risks of material misstatement, including fraud risks.
- The layout and presentation of the confirmation request.
- Prior experience on the audit or similar engagements.
- The method of communication (for example, in paper form or by electronic or other medium).
- Management's authorization or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorization.
- The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

.08 Determining that requests are properly addressed includes verifying the accuracy of the addresses, including testing the validity of some or all of the addresses on the confirmation requests before they are sent out, regardless of the confirmation method used. When a confirmation request is sent by e-mail, the auditor's determination that the request is being properly directed to the appropriate confirming party may include performing procedures to test the validity of some or all of the e-mail addresses supplied by management. The nature and extent of the necessary procedures is dependent on the risks associated with the particular type of confirmation or address. For example, a confirmation addressing a higher risk assertion or a confirmation address that appears to be potentially less reliable (for example, an electronic confirmation addressed in a manner that appears easier to falsify) may necessitate different or more extensive procedures to determine that the request is directed to the intended recipient. See further guidance in paragraphs .A14–.A15 of AU-C section 505 (discussed in paragraphs .30–.31 of this section).

Follow-Up on Confirmation Requests

.09 The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Types of Confirmation Requests

.10 Clients may prepare correspondence and confirmation requests on their own letterhead and submit to the auditor the signed originals and copies. The auditor may obtain one or more copies to serve as file copies for the current audit documentation, second requests, and manuscript copies for the next engagement.

.11 There are two types of external confirmation requests: the positive confirmation request and the negative confirmation request. A positive external confirmation request requests that the confirming party respond directly to the auditor by providing the requested information or indicating whether the confirming party agrees or disagrees with the information in the request. The negative confirmation request requests the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

.12 A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information or asking the confirming party to provide information. A response to a properly designed positive confirmation request ordinarily is expected to provide reliable audit evidence. A risk exists, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request and that ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required from the confirming parties to provide the requested information.

Using of Negative Confirmation Requests

.13 Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor should not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level, unless all of the following are present:

- The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.
- The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions, or conditions.
- A very low exception rate is expected.
- The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

.14 The failure to receive a response to a negative confirmation request does not indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor but less likely to respond otherwise. For example, holders of bank deposit accounts may be more likely to respond if they believe that the balance in their account is understated in the confirmation request but less likely to respond when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of bank deposit accounts may be a useful procedure in considering whether such balances may be understated but is unlikely to be effective if the auditor is seeking evidence regarding overstatement.

Accounts Receivable Confirmation Requests

.15 The auditor may perform the following for accounts receivable confirmation requests before they are mailed:

- Compare the names and addresses to the client's records
- Compare balances per confirmation requests to the subsidiary ledger

.16 The requests may then be sealed in envelopes and submitted to the post office under the auditor's control.

.17 In accordance with paragraph .07 of AU-C section 505 (discussed in paragraph .03 of this section), when using external confirmation procedures, the auditor should maintain control over external confirmation requests including sending the requests, including follow-up requests, when applicable, to the confirming party.

.18 In order to maintain control of the external confirmation process, the auditor may consider including the firm's office or post office box number as the return address on mailing envelopes so that undeliverable letters are returned to the auditor and not to the client. For mailings, the auditor may provide the envelopes or affix a label on the client's envelope that covers the client's return address and replaces it with the auditor's address.

.19 Reply envelopes addressed to the auditor may be enclosed with the request letter. Reply envelopes generally have prepaid postage to encourage responses. Some auditors also use codes on the reply envelopes so that responses may be sorted by engagement before the mail is opened. This feature may be particularly useful when there are several engagements that involve voluminous mailings.

.20 If the client objects to use of the auditor's name and address, some auditors suggest that a post office box in the client's name be used, with the returns to be opened under the auditor's control for the confirmation process, and that the post office be instructed that after the box is closed subsequent mail be forwarded to the auditor.

Management's Refusal to Allow the Auditor to Perform External Confirmation Procedures

.21 If management refuses to allow the auditor to perform external confirmation procedures, the auditor should

a. inquire about management's reasons for the refusal and seek audit evidence about their validity and reasonableness;

b. evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing, and extent of other audit procedures; and

c. perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

.22 A refusal by management to allow the auditor to perform external confirmation procedures is a limitation on the audit evidence the auditor seeks to obtain; therefore, the auditor is required to inquire about the reasons for the limitation. A common reason offered by management is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence about the validity and reasonableness of the reasons for management's refusal because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

.23 The auditor may conclude from the evaluation in paragraph .08*b* of AU-C section 505 (discussed in paragraph .21*b* of this section) that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures, in accordance with paragraph .32 of AU-C section 315. For example, if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation, in accordance with paragraph .24 of AU-C section 240.

.24 The alternative audit procedures that the auditor performs in accordance with paragraph .08*c* of AU-C section 505 (discussed in paragraph .21*c* of this section) may be similar to those appropriate for a nonresponse, as set out in paragraphs .A24–.A27 of AU-C section 505 (discussed in paragraphs .41–.44 of this section). Such procedures also would take into account the results of the auditor's evaluation in paragraph .08*b* of AU-C section 505 (see paragraph .21*b* in this section.)

.25 If the auditor concludes that management's refusal to allow the auditor to perform external confirmation procedures is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor should communicate with those charged with governance, in accordance with paragraph .12 of AU-C section 260. The auditor also should determine the implications for the audit and the auditor's opinion, in accordance with AU-C section 705.

Results of the External Confirmation Procedures

Reliability of Responses to Confirmation Requests

.26 If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor should obtain further audit evidence to resolve those doubts.

.27 If the auditor determines that a response to a confirmation request is not reliable, the auditor should evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing, and extent of other audit procedures.

.28 Paragraph .A32 of AU-C section 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability. All responses carry some risk of interception, alteration, or fraud. Such risk exists regardless of whether a response is obtained in paper form or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include whether it

- was received by the auditor indirectly or
- appeared not to come from the originally intended confirming party.

.29 The auditor's consideration of the reliability of the information obtained through the confirmation process to be used as audit evidence includes consideration of the risks that

- the information obtained may not be from an authentic source,
- a respondent may not be knowledgeable about the information to be confirmed, and
- the integrity of the information may have been compromised.

When an electronic confirmation process or system is used, the auditor's consideration of the risks described in the preceding list includes the consideration of risks that the electronic confirmation process is not secure or is improperly controlled.

.30 Responses received electronically (for example, by fax or e-mail) involve risks relating to reliability because proof of origin or identity of the confirming party may be difficult to establish, and alterations may be difficult to detect. The auditor may determine that it is appropriate to address such risks by utilizing a system or process that validates the respondent or by directly contacting the purported sender (for example, by telephone) to validate the identity of the sender of the response and to validate that the information received by the auditor corresponds to what was transmitted by the sender.

.31 An electronic confirmation system or process that creates a secure confirmation environment may mitigate the risks of interception or alteration. Creating a secure confirmation environment depends on the process or mechanism used by the auditor and the respondent to minimize the possibility that the results will be compromised because of interception or alteration of the confirmation. If the auditor is satisfied that such a system or process is secure and properly controlled, evidence provided by responses received using the system or process may be considered reliable. Various means might be used to validate the source of the electronic information. For example, the use of encryption, electronic digital signatures, and procedures to verify website authenticity may improve the security of the electronic confirmation system or process. If a system or process that facilitates electronic confirmation between the auditor and the respondent is in place and the auditor plans to rely on the controls over such a system or process, an assurance trust services report (for example, Systrust) or another assurance report on that system or process may assist the auditor in assessing the design and operating effectiveness of the electronic and manual controls with respect to that system or process. Such an assurance report may address the risks described in paragraph .A13 of AU-C section 505 (discussed in paragraph .29 of this section.) If these risks are not adequately addressed in such a report, the auditor may perform additional procedures to address those risks.

.32 The auditor is required by paragraph .10 of AU-C section 500 to determine whether to modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence. The auditor may choose to verify the source and contents of a response to a confirmation request by contacting the confirming party (for example, as described in paragraph .A14 of AU-C section 505 [discussed in paragraph .30 of this section]). When a response has been returned to the auditor indirectly (for example, because the confirming party incorrectly addressed it to the entity rather than the auditor), the auditor may request the confirming party to respond in writing directly to the auditor.

Disclaimers and Other Restrictions in Confirmation Responses

.33 A response to a confirmation request may contain restrictive language regarding its use. Such restrictions do not necessarily invalidate the reliability of the response as audit evidence. Whether the auditor may rely on the information confirmed and the degree of such reliance will depend on the nature and substance of the restrictive language.

.34 Restrictions that appear to be boilerplate disclaimers of liability may not affect the reliability of the information being confirmed. Examples of such disclaimers may include the following:

- Information is furnished as a matter of courtesy without a duty to do so and without responsibility, liability, or warranty, express or implied.
- The reply is given solely for the purpose of the audit without any responsibility on the part of the respondent, its employees, or its agents, and it does not relieve the auditor from any other inquiry or the performance of any other duty.

.35 Other restrictive language also may not affect the reliability of a response if it does not relate to the assertion being tested. For example, in a confirmation of investments, a disclaimer regarding the valuation of the investments may not affect the reliability of the response if the auditor's objective in using the confirmation request is to obtain audit evidence regarding whether the investments exist.

.36 Certain restrictive language may, however, cast doubt about the completeness or accuracy of the information contained in the response or on the auditor's ability to rely on such information. Examples of such restrictions may include the following:

- Information is obtained from electronic data sources, which may not contain all information in the respondent's possession.
- Information is not guaranteed to be accurate nor current and may be a matter of opinion.
- The recipient may not rely upon the information in the confirmation.

.37 When the auditor has doubts about the reliability of the response as a result of restrictive language, then, in accordance with paragraph .10 of AU-C section 505 (discussed in paragraph .26 of this section), the auditor is required to obtain further audit evidence to resolve those doubts. When the practical effect of the restrictive language is difficult to ascertain in the particular circumstances, the auditor may consider it appropriate to seek clarification from the respondent or seek legal advice.

.38 If the auditor is unable to resolve the doubts about the reliability of a response as a result of restrictive language, then, in accordance with paragraph .11 of AU-C section 505 (discussed in paragraph .27 of this section), the auditor is required to evaluate the implications on the assessment of the relevant risks of misstatement, including the risk of fraud, and on the related nature, timing, and extent of other audit procedures. The nature, timing, and extent of such procedures will depend on factors such as the nature of the financial statement item, the assertion being tested, the nature and substance of the restrictive language, and relevant information obtained through other audit procedures.

Unreliable Responses

.39 When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with paragraph .32 of AU-C section 315. For example, an unreliable response may indicate a fraud risk factor that requires evaluation, in accordance with paragraph .24 of AU-C section 240.

Nonresponses and Oral Responses

.40 In the case of each nonresponse, the auditor should perform alternative audit procedures to obtain relevant and reliable audit evidence.

.41 The nature and extent of alternative procedures are affected by the account and assertion in question. Examples of alternative audit procedures the auditor may perform include the following:

- For accounts receivable balances, examining specific subsequent cash receipts (including matching such receipts with the actual items being paid), shipping documentation, or other client documentation providing evidence for the existence assertion
- For accounts payable balances, examining subsequent cash disbursements or correspondence from third parties and other records, such as receiving reports and statements that the client receives from vendors providing evidence for the completeness assertion

.42 A nonresponse to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level and modify planned audit procedures, in accordance with paragraph .32 of AU-C section 315. For example, a fewer or greater number of responses to confirmation requests than anticipated may indicate a previously unidentified fraud risk factor that requires evaluation, in accordance with paragraph .24 of AU-C section 240.

.43 The auditor may determine that it is not necessary to perform additional alternative audit procedures beyond the evaluation of the confirmation results if such evaluation indicates that relevant and reliable audit evidence has already been obtained. This may be the case when testing for overstatement of amounts and (*a*) the nonresponses in the aggregate, projected as 100 percent misstatements to the population and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially misstated and (*b*) the auditor has not identified unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions.

.44 An oral response to a confirmation request does not meet the definition of an *external confirmation* because it is not a direct written response to the auditor. Provided that the auditor has not concluded that a direct written response to a positive confirmation is necessary to obtain sufficient appropriate audit evidence, the auditor may take the receipt of an oral response to a confirmation request into consideration when determining the nature and extent of alternative audit procedures required to be performed for nonresponses, in accordance with paragraph .12 of AU-C section 505 (discussed in paragraph .40 of this section.) The auditor may perform additional procedures to address the reliability of the evidence provided by the oral response, such as initiating a call to the respondent using a telephone number that the auditor has independently verified as being associated with the entity. For example, the auditor might call the main telephone number obtained from a reliable source and ask to be directed to the named respondent instead of calling a direct extension provided by the client or included in the statement or other correspondence received by the entity. The auditor may determine that the additional evidence provided by contacting the respondent directly, together with the evidence upon which the original confirmation request is based (for example, a statement or other correspondence received by the entity), is sufficient appropriate audit evidence. In appropriately documenting the oral response, the auditor may include specific details, such as the identity of the person from whom the response was received, his or her position, and the date and time of the conversation.

When a Written Response to a Positive Confirmation Request Is Necessary to Obtain Sufficient Appropriate Audit Evidence

.45 If the auditor has determined that a written response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor should determine the implications for the audit and the auditor's opinion, in accordance with AU-C section 705.

.46 In certain circumstances, the auditor may identify an assessed risk of material misstatement at the assertion level for which a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. Such circumstances may include the following:

- The information available to corroborate management's assertion(s) is only available outside the entity.
- Specific fraud risk factors, such as the risk of management override of controls or the risk of collusion, which can involve employee(s) or management, or both, prevent the auditor from relying on evidence from the entity.

.47 When the auditor has determined that a written response is necessary to obtain sufficient appropriate audit evidence and the auditor has obtained only an oral response to a confirmation request, the auditor may request the confirming party to respond in writing directly to the auditor. If no such response is received, in accordance with paragraph .13 of AU-C section 505 (discussed in paragraph .45 of this section), alternative audit procedures will not provide the audit evidence the auditor requires, and the auditor is required to determine the implications for the audit and the auditor's opinion, in accordance with AU-C section 705.

Exceptions

.48 The auditor should investigate exceptions to determine whether they are indicative of misstatements.

.49 Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required by paragraph .35 of AU-C section 240 to evaluate whether such misstatement is indicative of fraud. Exceptions may provide a guide to the quality of responses from similar confirming parties or for similar accounts. Exceptions also may indicate a deficiency, or deficiencies, in the entity's internal control over financial reporting.

.50 Some exceptions do not represent misstatements. For example, the auditor may conclude that differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the external confirmation procedures.

Evaluating the Evidence Obtained

.51 The auditor should evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence or whether further audit evidence is necessary.

.52 When evaluating the results of individual external confirmation requests, the auditor may categorize such results as follows:

- A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request or providing requested information without exception
- A response deemed unreliable
- A nonresponse
- A response indicating an exception

.53 The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether further audit evidence is necessary, as required by paragraphs .28–.29 of AU-C section 330.

.54 Further discussion about AU-C section 330, specifically evaluating audit evidence obtained, is provided in section 5100, "Audit Evidence and Designing Further Audit Procedures."

[*The next page is 7201.*]

AAM Section 7200

Requests for External Confirmations and Related Materials

This section contains the following reference from AICPA *Professional Standards*:

AU-C Section:

- AU-C section 505, *External Confirmations*

This section contains the following reference from other authoritative guidance:

- Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 715, *Compensation—Retirement Benefits*

Wording of External Confirmation Request Forms

.01 Forms and correspondence used for external confirmation requests should state clearly that the client is requesting that a reply be sent to the CPA.

.02 The samples of printed correspondence in this section include language that refers to auditors and an audit of the client's financial statements on the assumption that an audit is being performed. The language may be modified if services other than an audit are being performed.

.03 Request for Bank Cutoff Statement

Notes:

a. In accordance with paragraph .07*c* of AU-C section 505, the auditor should determine that the confirmation request is properly directed to the appropriate confirming party. Such appropriate confirming party may be the financial institution official who is responsible for the financial institution's relationship with the client or who is knowledgeable about the transactions or arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function.

b. Many banks now respond to electronic audit confirmation requests through www.confirmation.com. The auditor can submit the electronic request via the website, then a client contact will validate the request for the bank, and finally the bank will complete the form electronically and submit it directly back to the auditor.

c. The letter may also include requests for the following:

- Confirmation of all securities or other items held for the clients account as of the closing date for collection or safekeeping, or as agent or trustee (a listing should be provided including titles and account numbers).
- Confirmation of the list of authorized signers for the listed accounts. (This may have been previously requested at a preliminary date in connection with assessment of control risk.)

[*Prepared on Client's Letterhead*]

[*Date*]

Financial Institution Official
First United Bank
Anytown, USA 00000

In connection with an audit of the financial statements of [*name of client*] as of [*balance sheet date*] and for the [*period*] then ended, we request that you send the following information directly to our auditors [*name and address of auditors*] as of close of business [*balance sheet date*]:

1. The information requested on the enclosed standard form(s) to confirm account balance information with your financial institution.
2. For the following account numbers, statement(s) of our account(s) and the related paid checks for the period from [*balance sheet date*] to [*two weeks subsequent to the balance sheet date*] inclusive.

Account Number	*Account Name*

Sincerely,
[*Name of Customer*]

____

By:____________________

.04 Standard Form to Confirm Account Balance Information With Financial Institutions

Note:

a. Many banks now respond to electronic audit confirmation requests through www.confirmation.com. The auditor can submit the electronic request via the website, then a client contact will validate the request for the bank, and finally the bank will complete the form electronically and submit it directly back to the auditor.

STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

____
CUSTOMER NAME

Financial Institution's Name and Address [ ] [ ]

We have provided to our accountants the following information as of the close of business on ________________, 20_____, regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below.* Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

ACCOUNT NAME	ACCOUNT NO.	INTEREST RATE	BALANCE*

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

ACCOUNT NO./ DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL

______________________________ (Customer's Authorized Signature) ______________________________ (Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

______________________________ (Financial Institution Authorized Signature) ______________________________ (Date)

______________________________ (Title)

EXCEPTIONS AND/OR COMMENTS

Please return this form directly to our accountants: [ ] [ ]

* Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute. Additional forms available from: AICPA—Order Department, P.O. Box 1003, NY, NY 10108-1003 D 451 5951

.05 Request for Confirmation of Petty Cash Fund and Advances to Employees

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of the petty cash fund (or amount of advances) in your possession as of December 31, 20XX which was shown by our records as $_______.

Please indicate in the following space provided whether the amount above agrees with your records. If not, please send the auditors any information you have that will help them reconcile the difference.

After signing and dating your reply, please return it directly to the auditors. A stamped, addressed enveloped is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

The foregoing information is in agreement with my records as of December 31, 20XX, with the following exceptions (if any):

____

____

____

Date:______________________ Signed:______________________

.06 Securities and Cash in Custodian or Trust Accounts

Notes:

a. This letter may be expanded, if necessary, to request cutoff statements of activity (principal and interest) in the accounts.

b. Sometimes this request is combined with a request for cutoff bank statements and the standard form to confirm account balance information with financial institutions. However, it may be more practical to send separate letters because a bank's commercial banking and trust departments are usually separate operations.

c. The *Account No.* referenced should be the entity's custodian or trustee's account number.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Custodian or Trustee*]

[*Address*]

Our auditors, [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the enclosed list of securities owned at [*date*] and the amount of principal and income of cash held by you at that date for each of the following accounts:

[*If a list is not obtained from the client, the auditor may complete the following for each account:*

	Name of Account	*Account No.*	*Amount Held*
1.	________________	___________________	___________________
2.	________________	___________________	___________________
3.	________________	___________________	___________________

Please also indicate to the auditors whether or not to your knowledge any of the securities are pledged or otherwise encumbered.

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

.07 Securities Held by Brokers

Notes:

a. The request may be sent so it reaches the broker sufficiently in advance of the listing date for the broker to respond in a practical manner.

b. It may be helpful to include the account number(s) used by the broker for the client's account(s).

[*Prepared on Client's Letterhead*]

[*Date*]

[*Broker's Name*]

[*Address*]

In connection with the audit of our financial statements, please send directly to our auditors [*name and address of auditors*], a statement of our account(s) with you as of [*date*], indicating the following information:

1. Securities held by you for our account
2. Securities out for transfer to our name
3. Any amounts payable to or due from us

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

.08 Sample Receipts for Return of Cash or Securities Counted by Auditor's Representative and Cutoff Bank Statements Received Directly by the Auditors

Notes:

a. The auditor may request that receipt(s) be written and signed in *ink*.

b. For counts of petty cash funds, the receipt may be written directly on the bottom of the petty cash-count working paper. For security counts and returns of cutoff bank statements, the receipt may be prepared as a separate working paper.

Cash Count

The above detailed items were counted in my presence and returned to me intact by [*individual's name*], representative of [*auditor's firm name*].

[*Date and Time*] Custodian: ______________________________

[*Custodian's Signature*]

Securities Count

Received intact from [*individual's name*], representative of [*auditor's firm name*], the securities listed above contained in [*Box* ______] of the [*name of bank or custodian*] which were counted by him or her in my presence (or presented to him or her for count).

Date and Time: ____________________ Signed: ______________________________

Title: ______________________________

Cutoff Bank Statement(s)

Received intact from [*individual's name*], representative of [*auditor's firm name*], the cutoff bank statements and related paid checks for the [*period date range*] for the accounts listed in the following space provided:

Date and Time: ____________________ Signed: ______________________________

Title: ______________________________

.09 Accounts Receivable—Positive

[*Prepared on Client's Letterhead*]

[*Date*]

[*Customer Name*]

[*Address*]

In connection with the audit of our financial statements, please confirm directly to our auditors [*name and address of auditors*] the amount of your indebtedness to us which according to our records as of [*date*] amounted to $______.

If the amount shown is in agreement with your records, please check "A."

If the amount is not in agreement with your records, please check and complete "B."

After checking the appropriate response, please sign and date your reply and mail it directly to our auditors in the enclosed envelope. DO NOT SEND ANY PAYMENTS to our auditors.

Sincerely,

[*Client's Authorized Signature*]

A__________ The balance above agrees with my records.

B__________ My records show a balance of $______.

The difference may be due to the following:

____

____

____

____

[*Signed by*]

____

[*Date*]

.10 Accounts Receivable—Negative

Notes:

a. A negative confirmation request may also be requested in letter form, using similar wording.

b. The auditor may consider sending confirmation requests at the time of the client's regular monthly billings. Coordination of confirmation procedures with the client's routine preparation and mailing of statements may offer efficiency to both the auditor and client.

c. The auditor should not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level, unless all of the following are present:

   i. The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.

   ii. The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions, or conditions.

   iii. A very low exception rate is expected.

   iv. The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

[*May be a sticker or stamp used on client's statements to customers*]

PLEASE CHECK THIS STATEMENT

If this statement is *not correct* please write promptly (using the enclosed envelope), giving details of any differences, directly to our auditors, who are now conducting an audit of our financial statements.

[*Name of auditors*]

____

[*Address of auditors*]

____

____

If you do not write to our auditors, they will consider this statement to be correct.

Remittances should NOT be sent to the auditors.

.11 Notes Receivable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*] are performing an audit of our financial statements. Accordingly, please confirm directly to our auditors the amount of your indebtedness due us as of [*date*], which our records show as follows:

Type of indebtedness	______________
Initial date of indebtedness	______________
Original amount of indebtedness	______________
Unpaid principal	______________
Interest rate	______________
Interest paid to	______________
Periodic payments required	______________
Description of collateral	______________

If the above information is in agreement with your records, please so indicate by signing in the following space provided and then return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please so note in the following space provided the particulars shown in your records along with any information that may help reconcile the difference from our records. Payments should not be sent to the auditors.

Sincerely,

[*Client's Authorized Signature*]

The above information is correct as of [*date*] with the following exceptions (if any):

____

____

____

Signed: ______________________ Date: ______________________

.12 Inventories Held by Warehouses or Others When Listing Is Not Provided by Client

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Warehouse*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please send directly to our auditors the following information about merchandise held in your custody for our account as of [*date*]:

1. Quantities on hand. For each lot, please indicate the following:
   a. Lot number (list each lot separately)
   b. Date received
   c. Kind of merchandise
   d. Unit of measure or package
      i. Number of units
      ii. Kind of units (box, can, crate, quart, pound, dozen, or other unit)
2. A statement about how you determined the above requested quantities; specify whether they were determined by physical count, weight, or measure or if they represent your book record
3. A list of negotiable or nonnegotiable warehouse receipts issued (if any) and whether or not such receipts have, to your knowledge, been assigned or pledged
4. A statement of any known liens against this merchandise
5. The amount of unpaid charges, if any, as of [*date*]

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience

Sincerely,

[*Client's Authorized Signature*]

.13 Inventories Held by Warehouses or Others When Listing Is Provided by Client

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Warehouse*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about the merchandise held by you for our account as of [*date*]:

1. The correctness of the quantities shown on the enclosed listing of such merchandise prepared from our records (a second copy is enclosed for your files). If the enclosed listing differs from the quantities you held for us as of [*date*], please include details of the specific differences in your response to our auditors.

2. Your statement on how you determined the correctness of the quantities you are confirming; please specify whether it was determined by physical count, weight or measure, or whether the quantities are from your records.

3. A list of negotiable or nonnegotiable warehouse receipts issued, if any, and whether or not such receipts have, to your knowledge, been assigned or pledged.

4. A statement of any known liens against these goods.

5. The amount of any unpaid charges as of [*date*].

Please mail your reply directly to [*name and address of auditors*]. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

.14 Standard Confirmation Inquiry for Life Insurance Policies

STANDARD CONFIRMATION INQUIRY
FOR LIFE INSURANCE POLICIES

LIFE INSURANCE **STANDARD CONFIRMATION INQUIRY**

Developed by American Institute of Certified Public Accountants Life Office Management Association and Million Dollar Round Table

RETURN TO: [ ]

[ ]

Date:

Your completion of the following report will be sincerely appreciated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. Use the enclosed envelope to return the original directly to our accountant (see name to left).

Yours truly,

____
(Name of owner as shown on policy contract)

By _______________________
Authorized Signature

REPORT FROM INSURANCE COMPANY [ ]

[ ]

Information requested as of: ____________
(Date)

Additional forms available from
AICPA-ORDER
PO BOX 0946
NYC, NY 10108-0946

		Policy #1	Policy #2	Policy #3
	A. Policy Number			
	B. Insured-Name(s)			
	C. Beneficiaries as Shown on Policies (If Verification Requested in Item 11)			
1 Face Amount of Basic Policy				
2 Values Shown as of (Insert Date If Other Than Date Requested)				
3 Premiums, Including Prepaid Premiums, Are Paid to (Insert Date)				
4 Policy Surrender Value (Excluding Dividends, Additions & Indebtedness Adjustments)				
5 Surrender Value of All Dividend Credits, Including Accumulations & Additions				
6 Termination Dividend Currently Available on Surrender				
7 Other Surrender Values Available to Policy Owner	a. Prepaid Premium Value			
	b. Premium Deposit Funds			
	c. Other			
8 Outstanding Policy Loans, Excluding Accrued Interest				
9 If Any Policy Loans Exist, Complete Either "a" or "b"	a. Interest Accrued on Loans			
	b1. Loan Interest is Paid to (Enter Date)			
	b2. Interest Rate is (Enter Rate)			
NOTE: PLEASE ANSWER ANY ITEM(s) 10–12 INDICATED BY A (✓).				
☐ 10 Is There an Assignee of Record? (Enter Yes or No)				
☐ 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)		*	*	*
☐ 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: ☐ Yes ☐ No If No, Enter Name of Policy Owner of Record:				

* If Answer to Item 11 is "No." Please Give Name of Beneficiary or Date of Last Beneficiary Change:

Yours truly, (Insurance Company)

ORIGINAL
To be mailed to accountant

____________ Date

____________ Authorized Signature - Title

.15 Pension Plan Actuarial Information

> ***Note:*** FASB ASC 715 provides reduced disclosure requirements for nonissuers. Part C of this letter assumes companies have elected the reduced disclosures allowed by that statement. FASB ASC 715-20-50-5 describes the reduced disclosure requirements. For companies not electing the reduced disclosures, information required for disclosure can be obtained from parts B and D of the letter.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Actuary*]

[*Address*]

In connection with the audit of our financial statements for the period ending [*balance sheet date*] by our independent auditors [*name and address of auditors*], please furnish them the information described as follows as it pertains to the XYZ Pension Plan, which is a defined benefit plan. For your convenience and in response to those requests, you may supply pertinent sections, properly signed and dated, of your actuarial or pension expense report if they are available and if they contain the requested information.

A. Please provide a brief description of the following:

1. The employee group covered.
2. The benefit provisions of the plan used in the calculation of the net periodic pension cost for the period and of the accumulated benefit obligation and the projected benefit obligation at the end of the period. Please identify any such benefit provisions that had not taken effect in the year. Please also provide the date of the most recent plan amendment included in your calculation. Please identify any participants or benefits excluded from the calculations, such as benefits guaranteed under an insurance or annuity contract.
3. The percentages of the plan's assets that are invested in debt securities, equity securities, real estate, and any additional classifications of investment. Please identify the target compositions, if any, for the aforementioned classifications of investment groups.
4. A narrative description of the plan's investment policies and strategies, and the basis used to determine the expected long term rate of return on plan assets.
5. The method and the amortization period, if any, used for the following:
    a. Calculation of a market related value of plan assets, if different from the fair value
    b. Amortization of any transition asset or obligation
    c. Amortization of unrecognized prior service cost
    d. Amortization of unrecognized net gain or loss
6. Any substantive commitments for benefits that exceed the benefits defined by the written plan that are included in the calculations.
7. Determination of the value of any insurance or annuity contracts included in the assets.
8. Nature and effect of significant plan amendments and other significant matters affecting comparability of net periodic pension cost, funded status, and other information for the current period with that for the prior period.

9. The following information relating to the employee census data used in calculating the benefit obligations and pension cost:

   a. The source and nature of the data is ____________________ and the date as of which the census data was collected is __________________.

   b. The following information concerning participants:

Participants	*Number of Persons*	*Compensation (if applicable)*
Currently receiving payments	________	________
Active with vested benefits	________	________
Terminated with deferred vested benefits	________	________
Active without vested benefits	________	________
Other (describe)	________	________

> **Note:** *If information is not available for all the above categories, please indicate the categories that have been grouped and describe any group or groups of participants excluded from the above information.*

   c. Information for the following individuals contained in the census:

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

> **Note to Auditor:** *The auditor may select information from employer records to compare with the census data used by the actuary. In addition, the auditor may wish to have the actuary select certain census data from his or her files to compare with the employer's records.*

B. Please provide the following information on the net periodic pension cost for the period ending on __________:

1. Service cost	$	________
2. Interest cost		________
3. Expected return on assets		________
4. Other components		________
a. Amortization of unrecognized net loss or (gain) from earlier periods		________
b. Amortization of unrecognized prior service cost		________
c. Amortization of the remaining unrecognized net obligation or (asset) existing at the date of the initial application of Financial Accounting Standards Board *Accounting Standards Codification* 715, *Compensation—Retirement Benefits*—transition obligation or (asset)		________
d. Amount of loss (or gain) recognized due to a settlement or curtailment		________
e. Net total of components (*a*+*b*+*c*+*d*)	$	________
5. Net periodic pension cost: (1+2-3+4*e*)	$	________

(continued)

6. The above measurement of the net periodic pension cost is based on the following assumptions:

Weighted average discount rate	________	%
Weighted average rate of compensation increase	________	%
Weighted average expected long term rate of return on plan assets	________	%

Please describe the basis on which the above rates were selected and whether the basis is consistent with the prior period.

Please briefly describe the other assumptions used in the above measurement.

7. The calculations of the items shown in B1 and B5 are based on the following:

Asset information	________
Census data	________
Measurement date (must not be more than three months before the end of the last fiscal year)	________

Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in B1–B5.

C. Please provide the following information for disclosure in the financial statements for the period ending ______________:

			Estimated	
1.	Projected benefit obligation	$	________	
2.	Fair value of plan assets		________	
3.	Funded status of the plan (2-1)		________	
4.	Employer contributions to the plan		________	
5.	Participant contributions to the plan		________	
6.	Benefits paid		________	
7.	(Accrued) or prepaid pension cost in the company financial statements		________	
8.	The amount of any intangible asset or liability that is recognized may result in a temporary difference, as defined by Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740, *Accounting for Income Taxes*. The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated to various financial statement components, including other comprehensive income, pursuant to FASB ASC 740.		________	
9.	The amount of any accumulated other comprehensive income or liability that is recognized may result in a temporary difference, as defined by FASB ASC 740. The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated to various financial statement components, including other comprehensive income, pursuant to FASB ASC 740.		________	
10.	The amount included in other comprehensive income for the period arising from a change in the minimum pension liability recognized in accordance with FASB ASC 715, *Compensation—Retirement Benefits*.		________	
11.	The above amount of the projected benefit obligation is measured based on the following assumptions:			
	Weighted average discount rate		________	%
	Weighted average rate of compensation increase		________	%
	Please provide a brief description of the other assumptions used in the measurement.			

		Estimated
12.	The calculation of the items shown in C1–C10 is based on the following:	
	Asset information	________
	Census data	________
	Measurement date (must be not more than three months before the current fiscal year end)	________

Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in C1–C10.

13. Please describe any significant events noted subsequent to the current year's measurement date and as of the date of your reply to this request and the effects of those events, such as a large plant closing, which could materially affect the amounts shown in C1–C10.

14. Please describe any significant transactions between the employer or related parties and the plan during the period, including, if applicable, the amounts and types of securities of the employer and related parties included in plan assets and the amount of future annual benefits covered by insurance contracts issued by the employer or related parties.

D. Please provide an analysis for the period showing beginning amounts, additions, reductions, and ending amounts of the

1. projected benefit obligation,
2. fair value of plan assets,
3. unrecognized prior service cost,
4. unrecognized net loss (gain),
5. net transition obligation (asset), and
6. accumulated benefit obligation (ending amount only).

E. Please provide our independent auditors with descriptions and the amounts of gains or losses from combinations, divestitures, settlements, curtailments, or termination benefits during the year, such as

1. purchases of annuity contracts,
2. lump sum cash payments to plan participants,
3. other irrevocable actions that relieved the company or the plan of primary responsibility for a pension obligation and eliminated significant risks related to the obligation and assets,
4. any events that significantly reduced the expected years of future service of employees,
5. any events that eliminated for a significant number of employees the accrual of defined benefits for some or all of their future service, or
6. any special or contractual termination benefits offered to employees.

F. Please provide the amounts of anticipated cash payments for benefits for each of the next 5 years, as well as the expected aggregate amount of benefit payments for the subsequent 5 year period (years 6–10).

G. Was all of the information above determined in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 715 and the American Academy of Actuaries', *An Actuary's Guide to Compliance with Statement of Financial Accounting Standards No. 87* to the best of your knowledge? If not, please describe any differences.

H. Describe the nature of your relationship, if any, with the plan or the plan sponsor that may impair or appear to impair the objectivity of your work.

Please mail your response directly to [*audit firm's name and address*] in the enclosed return envelope as soon as possible, but no later than [*date*].

Sincerely,
[*Client's Authorized Signature*]

.16 Pension Plan Assets Held by Trustee

> ***Note:*** A listing of the assets might not be requested if one had already been received by the client. In that case, the auditor might want the trustee to confirm the total fair value per the listing.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Trustee or Custodian*]

[*Address*]

Our auditors [*name and address of auditor*] are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including fair values as of [*date*] for our employees' pension trust [*title and trustee's account number*].

Please also provide the auditors with the following information about our employees' pension trust for the period from [*beginning of period*] to [*end of period*]:

1. Contributions by the Company during the above period
2. Contributions by employees during the above period
3. Payments to beneficiaries during the above period
4. Any unpaid fees due for services rendered to [*balance sheet date*]

Please send your reply directly to our auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,
[*Client's Authorized Signature*]

.17 Notes Payable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements.

Accordingly, please confirm directly to them the following information relating to our note(s) payable to you, as of [*date*]:

Date of note		________	
Original amount	$	________	
Unpaid principal			
Balance	$	________	
Periodic payments required	$	________	
Payment periods		________	
Maturity date		________	
Interest rate		________	%
Date to which interest has been paid		________	
Amount and description of collateral		________	
Description of terms (for example, demand provisions and prepayment penalties)		________	
Any other direct or contingent liabilities to you (please write "None" or provide description)		________	

If the above information is in agreement with your records at that date, please so indicate by signing in the following space provided and return the copy of this letter directly to our auditors in the enclosed envelope.

If the above is not in agreement with your records, please note in the following space provided the particulars shown in your records and any information that may help reconcile the difference from our records.

Sincerely,
[*Client's Authorized Signature*]

The above information is correct as of [*date*] with the following exceptions (if any):

____

Date:______________________ Signature:______________________

Title:______________________

.18 Mortgage Debt

> ***Note:*** Many of the items requested will vary with the circumstance of the particular mortgage or other debt involved. This sample assumes the indenture involves an escrow arrangement for insurance and real estate taxes and a deposit account for repairs.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Creditor or Trustee*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about our mortgage indebtedness to you as of [*date*]:

1.	Original amount	$	________	
2.	Date of note		________	
3.	Unpaid principal balance	$	________	
4.	Interest rate		________	%
5.	Terms for payment of principal		________	
6.	Date to which interest has been paid		________	
7.	Nature of mortgage and description or address of property mortgaged		________	
8.	Amounts on deposit with you in escrow for			
	a. insurance	$	________	
	b. real estate taxes	$	________	
9.	Amounts paid during the period [*dates from and to*] for			
	a. insurance	$	________	
	b. taxes	$	________	
10.	Amounts on deposit with you for the reserve for repairs	$	________	
11.	The nature of defaults, if any		________	
12.	Description of terms (for example, prepayment penalties and demand provisions)		________	

A return envelope is enclosed for your reply.

Sincerely,

[*Client's Authorized Signature*]

.19 Accounts Payable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

In connection with the audit of our financial statements, please confirm directly to our auditors [*name and address of auditors*], the amount of our liability to you as of [*date*]. Please attach a statement of our account due. If no balance is due, please attach a statement of our account showing payments made.

Please mail your reply directly to [*name of auditors*]. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

Our records indicate that a balance of $________ was from [*name of client*] at [*date*].

Date: ______________________

Signature: ______________________

Title: ______________________

.20 Obligation to Lessor

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lessor*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements as of [*balance sheet date*] and for the [*time period*] then ended. In connection with this audit, please provide directly to our auditors the following information as of [*balance sheet date*] regarding the lease dated [*date lease was executed*] of [*brief identification of property under lease*] that we are leasing from you:

1. Inception and expiration dates for the lease period, from ______________ to ______________
2. Amount of monthly rent _________________
3. Renewal options (if any):
   - *a.* Dates of renewal period, from ______________ to ______________
   - *b.* Amount of monthly rent for renewal ______________
4. Purchase options (if any):
   - *a.* Amount of purchase price ______________
   - *b.* Inception and expiration dates of option, from ______________ to ______________
   - *c.* Percent of monthly rent (if any) applicable towards purchase price ______________
5. Dates and descriptions of amendments or supplementary understandings, if any, to the lease mentioned above.
6. The amount of outstanding delinquent payments, if any
7. A statement that there are no defaults or a statement of the nature of defaults, if any

A return envelope is enclosed for your reply.

Sincerely,

[*Client's Authorized Signature*]

.21 Property Out on Lease

> ***Notes:***
>
> *a.* If the leased property is of a mobile or portable nature such as a bulldozer or television camera, the confirmation may also include a request for specific serial numbers of significant equipment.
>
> *b.* In certain circumstances, the auditor may wish to consider confirming additional information such as renewal options, purchase options, and amendments or supplementary understandings.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lessee*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements as of [*balance sheet date*] and for the [*time period*] then ended. In connection with this audit, please confirm directly to our auditors the following information regarding the lease dated [*execution date of lease*] of [*brief identification of property under lease*] that you are leasing from us:

1. Inception and expiration dates of lease period from ______________ to ______________
2. Amount of monthly rent _________________
3. Total rent payments made _______________
4. Date of last payment ___________________

A return envelope is enclosed for your reply.

Sincerely,

[*Client's Authorized Signature*]

.22 Register—Capital Stock

> ***Notes:***
>
> *a.* It may be helpful to include the registrar's account number for the client's account to receive a timely response.
>
> *b.* Some auditors prefer that the confirmation request include identification of each class of stock.
>
> *c.* This illustration assumes the client has a separate transfer agent (see paragraph .23).

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Registrar*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of the close of business [*balance sheet date*] about each class of our preferred and common stock:

1. Authorized number of shares ____________________
2. Issued number of shares ______________________
3. Outstanding number of shares ___________________

Please also indicate the amount of any unpaid registrar fees due you as of [*balance sheet date*].

A return envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

The above information agrees with our records at [*balance sheet date*] with the following exceptions:

____

____

____

Signed: ______________________________ Date: ______________________________

[*Name and Title*]

.23 Transfer Agent—Capital Stock

Notes:

a. It may be helpful to include the transfer agent's account number for the client's account to receive a timely response.

b. Some auditors prefer that the confirmation request include identification of each class of stock.

c. Depending on the auditor's judgment in the circumstances, the confirmation request may also include inquiries about such matters as

i. the number of shares issued to each of specifically mentioned officers and directors,

ii. specified information about shareholders owning more than a stated percent of the total outstanding shares, and

iii. amounts deposited during the year for the payment of dividends.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Transfer Agent*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of [*balance sheet date*] about each class of our preferred and common stock:

1. Authorized number of shares ____

2. Number of shares issued and outstanding ____

3. Number of outstanding shares registered in the name of our Company ____________________

Please also indicate the amount of any unpaid transfer agent fees due you as of [*balance sheet date*].

A return envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

The above information agrees with our records at [*balance sheet date*] with the following exceptions:

____

____

____

Signed: ______________________________ Date: ______________________________

[*Name and Title*]

.24 Request for Confirmation of Money Market Fund

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of our money market fund account(s) as of [*date*].

Please indicate in the following space provided the account number(s) and balance(s) of our account(s) per your records.

Please sign and date your reply and return it directly to the auditors. A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

Account No.	*Date*	*Balance*

Date: ______________________ Signed: ______________________

.25 Confirmation of Contingent Liabilities

> ***Note:*** In accordance with paragraph .07*c* of AU-C section 505, the auditor should determine that the request is properly addressed to the appropriate confirming party. The appropriate confirming party may be a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements. Some official institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function.

[*Date*]

Financial Institution Official

First United Bank
Anytown, USA 00000

In connection with an audit of the financial statements of [*name of customer*] as of [*balance sheet date*] and for the [*period*] then ended, we have advised our independent auditors of the following listed information, which we believe is a complete and accurate description of our contingent liabilities, including oral and written guarantees, with your financial institution. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other contingent liabilities, including oral and written guarantees, from your financial institution comes to your attention, please include such information in the following space provided.

Name of Maker	**Date of Note**	**Due Date**	**Current Balance**
Interest Rate	**Date Through Which Interest is Paid**	**Description of Collateral**	**Description of Purpose of Note**

Information related to oral and written guarantees is as follows:

____
____
____

Please confirm whether the information about contingent liabilities presented above is correct by providing a signature below and returning this directly to our independent auditors [*name and address of CPA firm*].

Sincerely,

[*Name of Customer*]

____

By: ________________________________

[*Authorized Signature*]

____

Dear CPA Firm:

The above information listing contingent liabilities, including oral and written guarantees, agrees with the records of this financial institution. Although we have not conducted a comprehensive, detailed search of our records, no information about other contingent liabilities, including oral and written guarantees, came to our attention. (Note exceptions below or in an attached letter.)

____

____

____

____

____
[*Name of Financial Institution*]

By: ______________________ ______________
[*Officer*] [*Date*]

____
[*Title*]

.26 Confirmation of Compensating Balances

> ***Note:*** In accordance with paragraph .07*c* of AU-C section 505, the auditor should determine that the request is properly addressed to the appropriate confirming party. The appropriate confirming party may be a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements. Some official institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function.

[*Date*]

Financial Institution Official

First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of [*name of customer*] as of [*balance sheet date*] and for the [*period*] then ended, we have advised our independent auditors that as of the close of business on [*balance sheet date*] there (were) (were not) compensating balance arrangements as described in our agreement dated [*date*]. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other compensating balance arrangements between [*name of customer*] and your financial institution comes to your attention, please include such information below. Withdrawal by [*name of customer*] of the compensating balance (was) (was not) legally restricted at [*date*]. The terms of the compensating arrangements at [*date*] were:

EXAMPLES:

1. The Company has been expected to maintain an average compensating balance of 20 percent of its average loan understanding, as determined from the financial institution's ledger records adjusted for estimated average uncollected funds.
2. The Company has been expected to maintain an average compensating balance of $100,000 during the year, as determined from the financial institution's ledger records without adjustment for uncollected funds.
3. The Company has been expected to maintain a compensating balance, as determined from the financial institution's ledger records without adjustment for uncollected funds, of 15 percent of its outstanding loans plus 10 percent of its unused line of credit.
4. The Company has been expected to maintain as a compensating balance noninterest bearing time deposits of 10 percent of its outstanding loans.

In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of _____ [*business calendar*] days.[1]

There (were the following) (were no) changes in the compensating balance arrangements during the [*period*] and subsequently through the date of this letter.

The Company (was) (was not) in compliance with the compensating balance arrangements during the [*period*] and subsequently through the date of this letter.

[1] This is not applicable if compensating balances are based on the financial institution's ledger records without adjustment for uncollected funds. If some other method is used by the financial institution for determining collected funds for compensating balance purposes, the method used may be described.

There (were the following) (were no) sanctions (applied or imminent) by the financial institution because of non-compliance with compensating balance arrangements.[2]

During the [*period*], and subsequently through the date of this letter, (no) (the following) compensating balances were maintained by the Company at the financial institution on behalf of an affiliate, director, officer, or any other third party, and (no) (the following) third party maintained compensating balances at the bank on behalf of the Company. (Withdrawal of such compensating balances (was) (was not) legally restricted.)

Please confirm whether the information about compensating balances presented above is correct by signing in the following space provided and returning this letter directly to our independent auditors [*name and address of CPA Firm*].

Sincerely,

[*Name of Customer*]

____

By: ______________________________

[*Authorized Signature*]

Dear CPA Firm:

The above information regarding the compensating balance arrangements with this financial institution agrees with the records of this financial institution. Although we have not conducted a comprehensive, detailed search of our records, no information about other compensating balance arrangements, came to our attention. (Note exceptions in the following space provided or in an attached letter.)

____
____
____

____

[*Name of Financial Institution*]

By: ______________________________ ______________

[*Officer*] [*Date*]

____

[*Title*]

[2] This is applicable only if the financial institution has applied sanctions during the [*period*] or notified the Company that sanctions may be applied. The confirmation request may indicate details of the sanctions.

.27 Confirmation of Lines of Credit

> ***Note:*** In accordance with paragraph .07*c* of AU-C section 505, the auditor should determine that the request is properly addressed to the appropriate confirming party. The appropriate confirming party may be a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the transactions or arrangements. Some official institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function.

[*Date*]

Financial Institution Official

First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of [*name of client*] as of [*balance sheet date*] and for the [*period*] then ended, we have advised our independent auditors of the following information that we believe is a complete and accurate description of our line of credit from your financial institution as of the close of business on [*balance sheet date*]. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other lines of credit from your financial institution comes to your attention, please include such information in the following space provided.

The Company has available at the financial institution a line of credit totaling $[*amount*]. The current terms of the line of credit are contained in the letter dated [*date*]. The related debt outstanding at the close of business on [*date*] was $[*amount*].

The amount of unused line of credit, subject to the terms of the related letter, at [*date*] was $[*amount*].

Interest rate at the close of business on [*date*] was _____ percent.

Compensating balance arrangements are:

____

____

____

This line of credit supports commercial paper (or other borrowing arrangements) as described in the following space provided:

____

____

____

Please confirm whether the information about lines of credit presented above is correct by signing in the following space provided and returning this letter directly to our independent auditors [*name and address of CPA Firm*].

Sincerely,

[*Name of Client*]

____

By: ______________________________

[*Authorized Signature*]

____

Dear CPA Firm:

The above information regarding the line of credit arrangements agrees with the records of this financial institution. Although we have not conducted a comprehensive, detailed search of our records, no information about other lines of credit came to our attention. (Note exceptions in the following space provided or in an attached letter.)

____

____

____

____
[*Name of Financial Institution*]

By: ______________________ ____________

[*Officer*] [*Date*]

____

[*Title*]

.28 Related Party Confirmation

In certain situations, the auditor may want to confirm the existence of related parties with directors, principal officers, major shareholders, or others. The following is an illustrative related party confirmation letter that an auditor may use when the auditor determines to obtain additional audit evidence regarding the existence of related parties or related party transactions.

[*Date*]

[*Name of Director, Principal Officer, or Major Stockholder*]

[*Address*]

Dear [*Name*]:

In connection with an audit of our financial statements, please furnish answers to the attached questionnaire, sign your name, and return the questionnaire in the enclosed stamped, addressed envelope directly to our auditors [*name and address of auditors*]. The questionnaire is designed to provide the auditors with information about the interests of officers, directors, and other related parties in transactions with the Company.

Please answer all questions. If the answer to any question is "yes," please explain why it is so. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions. Thank you for your cooperation.

Sincerely,

____

[*Client's Authorized Signature*]

____

[*Title*]

[*Client Name*]

Related Party Questionnaire

Please answer all questions. If the answer to any question is "yes," please explain why it is so. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions.

1. Have you or any related party of yours had any interest, direct or indirect, in any sales, purchases, transfers, leasing arrangements, guarantees, or other transactions since [*beginning of period of audit*] to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?

2. Do you or any related party of yours have any interest, direct or indirect, in any pending or incomplete sales, purchases, transfers, leasing arrangements, guarantees or other transactions to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) is, or is to be, a party?

3. Have you or any related party of yours been indebted to the Company (or specify any pension, retirement, savings, or similar plan provided by the client) at any time since [*beginning of period of audit*]? Please exclude amounts due for purchases on usual trade terms and for ordinary travel and expense advances.

The answers to the foregoing questions are correct to the best of my knowledge and belief.

____________________________________ ____________________________________

[*Signature*] [*Date*]

.29 Safe Deposit Box Access Confirmation

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*], are conducting an audit of our financial statements. Accordingly, please confirm there has been no access to our safe deposit box number _____ between _____ and _____ o'clock.

Please indicate in the following space provided if the previous statement is in agreement with your records. If it is not, please furnish the auditors any details concerning access to our safe deposit box during the period indicated.

After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Sincerely,

[*Client's Authorized Signature*]

According to our records, there has been no access to the above described safe deposit box during the period specified, except as follows:

____

____

Signed: ______________________________ Date: ______________________________

[*Name and Title*]

.30 Insurance In Force Confirmation Request

[*Date*]

[*Name*]

[*Address*]

Our auditors, [*name and address of auditors*], are conducting an audit of our financial statements. In that connection, please confirm the details of our insurance coverage in force at ____________________ [*balance sheet date*] as described in the following space provided:

Policy number	____________	____________
Insurance company	____________	____________
Type of coverage	____________	____________
Amount of coverage	____________	____________
Co-insurance, if any	____________	____________
Term of policy	____________	____________
Gross premium	____________	____________
Amount of unpaid premiums	____________	____________
Loss payees, if other than us	____________	____________
Claims pending at ___________________________ [*date*]	____________	____________

Please compare this information with your records and inform our auditors, in the following space, if it is or is not in agreement with your records. After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Sincerely,

____
[*Client's Authorized Signature*]

The above information agrees with our records at ______________ [*balance sheet date*] with the following exceptions:

____
____
____

Signed: ____________________________________ Date: ____________________________________
[*Name and Title*]

[*The next page is 7301.*]

AAM Section 7300

Litigation, Claims, and Assessments and Inquiries to Legal Counsel

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items*
- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

Other authoritative guidance referenced in this section:

- FASB *Accounting Standards Codification* (ASC) 450, *Contingencies*

Litigation, Claims, and Assessments

.01 The auditor should design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement, including

- inquiring of management and, when applicable, others within the entity, including in-house legal counsel;
- obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the date of the financial statements being reported on and during the period from the date of the financial statements to the date the information is furnished, including an identification of those matters referred to legal counsel; and
- reviewing minutes of meetings of those charged with governance; documents obtained from management concerning litigation, claims, and assessments; and correspondence between the entity and its external legal counsel; and
- reviewing legal expense accounts and invoices from external legal counsel.

.02 For actual or potential litigation, claims, and assessments identified based on the audit procedures required in paragraph .16 of AU-C section 501, the auditor should obtain audit evidence relevant to the following factors:

- The period in which the underlying cause for legal action occurred
- The degree of probability of an unfavorable outcome
- The amount or range of potential loss

.03 Additional guidance regarding the completeness of litigation, claims, and assessments involving the entity is provided in paragraphs .A39–.A45 of AU-C section 501.

.04 Direct communication with the entity's legal counsel assists the auditor in obtaining sufficient appropriate audit evidence about whether potentially material litigation, claims, and assessments are known and management's estimates of the financial implications, including costs, are reasonable.

.05 If a client has not needed to retain legal counsel, the auditor may express an unqualified opinion on the financial statements even though he or she has not obtained a letter from legal counsel of the company. In these circumstances, the auditor may consider obtaining written representation from the company that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation. Paragraphs .16 and .A45 of AU-C section 501 provide requirements and guidance for auditors when the client has not retained legal counsel during the period under audit.

Communication With the Entity's Legal Counsel

.06 Unless the audit procedures required by paragraph .16 of AU-C section 501 (discussed in paragraph .01 of this section) indicate that no actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement exist, the auditor should, in addition to the procedures required by other AU-C sections, seek direct communication with the entity's external legal counsel. The auditor should do so through a letter of inquiry prepared by management and sent by the auditor requesting the entity's external legal counsel to communicate directly with the auditor.

.07 In certain circumstances, the auditor also may judge it necessary to meet with the entity's legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, when

- the auditor determines that the matter is a significant risk.
- the matter is complex.
- a disagreement exists between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

.08 In addition to the direct communications with the entity's external legal counsel referred to in paragraph .18 of AU-C section 501 (discussed in paragraph .06 of this section), the auditor should, in cases when the entity's in-house legal counsel has the responsibility for the entity's litigation, claims, and assessments, seek direct communication with the entity's in-house legal counsel through a letter of inquiry similar to the letter referred to in paragraph .18 of AU-C section 501. Audit evidence obtained from in-house legal counsel in this manner is not, however, a substitute for the auditor seeking direct communication with the entity's external legal counsel, as described in paragraph .18 of AU-C section 501.

.09 The auditor should document the basis for any determination not to seek direct communication with the entity's legal counsel, as required by paragraphs .18–.19 of AU-C section 501 (see preceding paragraphs .06 and .08, respectively).

.10 The auditor should request management to authorize the entity's legal counsel to discuss applicable matters with the auditor.

.11 A letter of inquiry to the entity's legal counsel is the auditor's primary means of obtaining corroboration of the information provided by management concerning material litigation, claims, and assessments. Audit evidence obtained from the entity's in-house general counsel or legal department may provide the auditor with the necessary corroboration.

.12 As described in paragraphs .18–.19 of AU-C section 501 (see preceding paragraphs .06 and .08, respectively), the auditor should request, through letter(s) of inquiry, the entity's legal counsel to inform the auditor of any litigation, claims, assessments, and unasserted claims that the counsel is aware of, together with an assessment of the outcome of the litigation, claims, and assessments, and an estimate of the financial implications, including costs involved. Each letter of inquiry should include, but not be limited to, the following matters:

a. Identification of the entity, including subsidiaries, and the date of the audit

b. A list prepared by management (or a request by management that the legal counsel prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the legal counsel has been engaged and to which the legal counsel has devoted substantive attention on behalf of the company in the form of legal consultation or representation

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 with respect to which the legal counsel has been engaged and to which the legal counsel has devoted substantive attention on behalf of the entity in the form of legal consultation or representation

d. Regarding each matter listed in item *b*, a request that the legal counsel either provide the following information or comment on those matters on which the legal counsel's views may differ from those stated by management, as appropriate:

i. A description of the nature of the matter, the progress of the case to date, and the action that the entity intends to take (for example, to contest the matter vigorously or to seek an out-of-court settlement)

ii. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss

iii. With respect to a list prepared by management (or by the legal counsel at management's request), 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. Regarding each matter listed in item *c*, a request that the legal counsel comment on those matters on which the legal counsel's views concerning the description or evaluation of the matter may differ from those stated by management

f. A statement that management understands that whenever, in the course of performing legal services for the entity with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the legal counsel has formed a professional conclusion that the entity should disclose or consider disclosure concerning such possible claim or assessment, the legal counsel, as a matter of professional responsibility to the entity, will so advise the entity and will consult with the entity concerning the question of such disclosure and the requirements of the applicable financial reporting framework (for example, the requirements of FASB ASC 450

g. A request that the legal counsel confirm whether the understanding described in item *f* is correct

h. A request that the legal counsel specifically identify the nature of, and reasons for, any limitation on the response

i. A request that the legal counsel specify the effective date of the response

.13 When the auditor is aware that an entity has changed legal counsel or that the legal counsel previously engaged by the entity has resigned, the auditor should consider making inquiries of management or others about the reasons such legal counsel is no longer associated with the entity.

.14 The auditor should modify the opinion in the auditor's report, in accordance with AU-C section 705, if

- the entity's legal counsel refuses to respond appropriately to the letter of inquiry and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures or
- management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel.

.15 Additional guidance regarding communication with the entity's legal counsel is provided in paragraphs .A46–.A65 of AU-C section 501. Illustrative audit inquiry letters to legal counsel are provided in the following paragraphs.

.16 Illustrative Audit Inquiry Letter to Legal Counsel

Notes:

a. The "Illustrative Audit Inquiry Letter to Legal Counsel" was extracted from the appendix, "Illustrative Audit Inquiry Letter to Legal Counsel," to AU-C section 501.

b. Paragraph .22 of AU-C section 501 discusses the matters that should be covered in a letter of audit inquiry.

c. Although it may be beneficial to send the audit inquiry letter to legal counsel so that the lawyer's response is dated as close to the auditor's report date as practical, the auditor and client may consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lawyer*]

[*Address of Lawyer*]

Dear [*Name*]:

In connection with an audit of our financial statements at (*balance sheet date*) and for the (*period*) then ended, management of the Company has prepared, and furnished to our auditors (*name and address of auditors*), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (*balance sheet date*) and during the period from that date to the date of your response.

Pending or Threatened Litigation (Excluding Unasserted Claims)

[*Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.*] This letter will serve as our consent for you to furnish to our auditor all the information requested herein. Accordingly, please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and 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.

Unasserted Claims and Assessments (Considered by Management to be Probable of Assertion, and That, if Asserted, Would Have at Least a Reasonable Possibility of an Unfavorable Outcome)

[*Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.*] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[*The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others*.]

Sincerely,

[*Authorized Signature for Client*]

.17 Illustrative Inquiry Letter to Legal Counsel If Management Has Not Provided Details About Pending or Threatened Litigation

Notes:

a. Paragraph .22 of AU-C section 501 discusses the matters that should be covered in a letter of audit inquiry.

b. If a client has not needed to retain legal counsel, an unqualified opinion may be expressed on the financial statements even though a letter from legal counsel has not been obtained provided that the requirements in AU-C section 700 have been met. In these circumstances, the auditor may consider obtaining a written representation from the company that legal counsel has not been retained for matters concerning its operations that involve current or prospective litigation. Paragraph .A45 of AU-C section 501 provides guidance for auditors when the client has not retained legal counsel during the period under audit.

c. Although it may be beneficial to send the audit inquiry letter to legal counsel so that the lawyer's response is dated as close to the auditor's report date as practical, the auditor and client may consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lawyer*]

[*Address of Lawyer*]

Dear [*Name*]:

In connection with an audit of our financial statements at [*balance sheet date*] and for the [*period*] then ended, please furnish our auditors [*name and address of auditors*], with the information requested below concerning certain contingencies involving matters with respect to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. [*When a materiality limit has been established based on an understanding between management and the auditor, the following sentence should be added: This request is limited to contingencies amounting to (amount) individually or items involving lesser amounts that exceed (amount) in the aggregate*.]

Pending or Threatened Litigation, Claims and Assessments (Excluding Unasserted Claims)

Regarding pending or threatened litigation, claims, and assessments, please include in your response:

1. The nature of each matter
2. The progress of each matter to date
3. How the Company is responding or intends to respond (for example, to contest the case vigorously or seek an out-of-court settlement), and
4. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss

Unasserted Claims and Assessments

We have represented to our auditors that there are no unasserted possible claims or assessments that you have advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies.* We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, you have formed a professional conclusion that we should disclose or consider disclosing concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of FASB ASC 450. Please specifically confirm to our auditors that our understanding is correct. Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the organization, such as guarantees of indebtedness of others.]

Your response should include matters that existed at (*balance-sheet date*) and during the period from that date to the effective date of your response. Please specifically identify the nature of and reasons for any limitations on your response. Our auditors expect to have the audit completed about (*expected completion date*). They would appreciate receiving your reply by that date with a specified effective date no earlier than (*ordinarily two weeks before expected completion date*).

Sincerely,

[*Authorized Signature for Client*]

.18 Illustrative Inquiry Letter to Legal Counsel If Management Believes That There Are No Unasserted Claims or Assessments That Are Probable of Assertion and That, If Asserted, Would Have a Reasonable Possibility of An Unfavorable Outcome as Specified by FASB ASC 450

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lawyer*]

[*Address of Lawyer*]

Dear [*Name*]:

In connection with an audit of our financial statements at (*balance sheet date*) and for the (*period*) then ended, management of the Company has prepared, and furnished to our auditors (*name and address of auditors*), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (*balance sheet date*) and during the period from that date to the date of your response.

Pending or Threatened Litigation (Excluding Unasserted Claims)

[*Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.*] This letter will serve as our consent for you to furnish to our auditor all the information requested herein. Accordingly, please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and 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.

We have represented to our auditors that there are no unasserted possible claims that you have advised us are probable of assertion and must be disclosed, in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of FASB ASC 450. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[*The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.*]

Sincerely,

[*Authorized Signature for Client*]

.19 Improving Inquiry Techniques

If inquiries to legal counsel are not sufficiently detailed or specific, deficiencies in attorneys' responses may result. A meeting between the auditor and the attorney may be necessary to clarify the attorney's written response, and paragraph .A50 of AU-C section 501 provides for such a meeting. However, to improve the auditor's ability to receive all of the information necessary to complete his or her audit, he or she may consider the following matters in an inquiry to legal counsel:

- A request that the attorney specify the effective date of his or her response, if it is other than the date of the reply.
- A request that the attorney mail the response so that it will be received by a certain date.
- A request that the nature of any litigation specifically identify
  - the proceedings,
  - the claim(s) asserted,
  - the amount of monetary damages sought, or if no amounts are indicated in preliminary case filings, a statement to that effect, and
  - the objectives sought by the plaintiff, if any, other than monetary or other damages (such as performance or discontinued performance of certain actions).
- A request that the attorney avoid such vague phrases as *meritorious defenses*, *without substantial merit*, and *reasonable chance* in expressing an opinion on the outcome of litigation.
- A request that the attorney specify to what extent potential damages are covered by insurance. (It may be possible to obtain the opinion of the insurer's counsel regarding the applicability of insurance coverage.)
- A request that the attorney provide a summary of material litigation, claims, and assessments settled during the period.
- A statement that confirmation of the understanding regarding disclosure of unasserted claims and assessments is an integral part of the audit inquiry and that failure to so confirm will require a follow-up contact.
- A statement that the attorney's response will not be quoted or referred to in the financial statements without first consulting with him or her.

[*The next page is 7401.*]

AAM Section 7400

Written Representations and Representation Letters

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 260, *The Auditor's Communication With Those Charged With Governance*
- AU-C section 450, *Evaluation of Misstatements Identified During the Audit*
- AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*
- AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- AU-C section 580, *Written Representations*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- AU-C section 930, *Interim Financial Information*

.01 Paragraph .03 of AU-C section 580 states that written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written rather than oral representations, in many cases, may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations. AU-C section 580 establishes requirements and provides guidance regarding the auditor's responsibility to obtain written representations from management and, when appropriate, those charged with governance in an audit of financial statements.[1]

.02 Although written representations provide necessary audit evidence, they complement other auditing procedures and do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, obtaining reliable written representations does not affect the nature or extent of other audit procedures that the auditor applies to obtain audit evidence about the fulfillment of management's responsibilities or about specific assertions.

.03 Accordingly, the auditor should request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

.04 Written representations are requested from those with overall responsibility for financial and operating matters whom the auditor believes are responsible for, and knowledgeable about, directly or through others in the organization, the matters covered by the representations, including the preparation and fair presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer or other equivalent persons in entities that do not use such titles. In some circumstances, however, other

[1] AICPA Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), provides nonauthoritative guidance for auditors when conducting audits in accordance with generally accepted auditing standards. TIS section 9100.06 discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. TIS section 9100.06 indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.

parties, such as those charged with governance, also are responsible for the preparation and fair presentation of the financial statements.

.05 Due to its responsibility for the preparation and fair presentation of the financial statements and its responsibility for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing the financial statements and the assertions therein on which to base the written representations.

.06 In some cases, however, management may decide to make inquiries of others who participate in preparing the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include the following:

- An actuary responsible for actuarially determined accounting measurements
- Staff engineers who may have responsibility for environmental liability measurements
- Internal counsel who may provide information essential to provisions for legal claims

.07 To reinforce the need for management to make informed representations, the auditor may request that management include in the written representations confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations. It is not expected that such inquiries would usually require a formal internal process beyond those already established by the entity.

.08 In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if, in the auditor's professional judgment, the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

.09 For purposes of AU-C section 580, references to *management* are to be read as "management and, when appropriate, those charged with governance" unless the context suggests otherwise.

Written Representations About Management's Responsibilities

Preparation and Fair Presentation of the Financial Statements

.10 The auditor should request management to provide written representation that it has fulfilled its responsibility, as set out in the terms of the audit engagement,

- for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; and.
- for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Information Provided and Completeness of Transactions

.11 The auditor should request management to provide written representations that

- it has provided the auditor with all relevant information and access, as agreed upon in the terms of the audit engagement, and
- all transactions have been recorded and are reflected in the financial statements.

Other Written Representations

Fraud

.12 The auditor should request management to provide written representations that it

- acknowledges its responsibility for the design, implementation, and maintenance of internal controls to prevent and detect fraud;
- has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving
    - — management,
    - — employees who have significant roles in internal control, or
    - — others when the fraud could have a material effect on the financial statements; and
- has disclosed to the auditor its knowledge of any allegations of fraud or suspected fraud affecting the entity's financial statements communicated by employees, former employees, regulators, or others.

The written representations relating to fraud are important for the auditor to obtain, regardless of the size of the entity, because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud.

Laws and Regulations

.13 The auditor should request management to provide written representations that all instances of identified or suspected non-compliance with laws and regulations whose effects should be considered by management when preparing financial statements have been disclosed to the auditor.

Uncorrected Misstatements

.14 The auditor should request management to provide written representations about whether it believes the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole. A summary of such items should be included in, or attached to, the written representation.

.15 Because the preparation of the financial statements requires management to adjust the financial statements to correct material misstatements, the auditor is required to request management to provide a written representation about uncorrected misstatements. In some circumstances, management may not believe that certain uncorrected misstatements are misstatements. For that reason, management may want to add to their written representation words such as "We do not agree that items ... and ... constitute misstatements because [*description of reasons*]." Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements in accordance with AU-C section 450.

Litigations and Claims

.16 The auditor should request management to provide written representations that all known actual or possible litigation and claims whose effects should be considered by management when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

Estimates

.17 The auditor should request management to provide written representations about whether it believes significant assumptions used by it in making accounting estimates are reasonable.

.18 Depending on the nature, materiality, and extent of estimation uncertainty, written representations about accounting estimates recognized or disclosed in the financial statements may include representations

- about the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework and the consistency in the application of the processes.
- that the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity when relevant to the accounting estimates and disclosures.
- that disclosures related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- that no subsequent event has occurred that would require adjustment to the accounting estimates and disclosures included in the financial statements.

.19 For those accounting estimates not recognized or disclosed in the financial statements, written representations also may include representations about the following:

- The appropriateness of the basis used by management for determining that the criteria of the applicable financial reporting framework for recognition or disclosure have not been met
- The appropriateness of the basis used by management to overcome a presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework for those accounting estimates not measured or disclosed at fair value

Related Party Transactions

.20 The auditor should request management to provide written representations that

a. it has disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which it is aware and

b. it has appropriately accounted for and disclosed such relationships and transactions.

.21 Circumstances in which it may be appropriate to obtain written representations about related parties from those charged with governance in addition to management include the following:

- When they have approved specific related party transactions that (*a*) materially affect the financial statements or (*b*) involve management
- When they have made specific oral representations to the auditor on details of certain related party transactions
- When they have financial or other interests in the related parties or the related party transactions

.22 The auditor also may decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.

Subsequent Events

.23 The auditor should request management to provide written representations that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

.24 Paragraph .13 of AU-C section 560 addresses circumstances when the auditor includes an additional date in the auditor's report on the revised financial statements that is limited to the revision (that is, dual-date the auditor's report for that revision), thereby indicating that the auditor's procedures subsequent to the original date of the auditor's report are limited solely to the revision of the financial statements described in the relevant note to the financial statements. In such circumstances, the auditor should request written representations from management as of the additional date in the auditor's report relating to the subsequent event.

Additional Written Representations About the Financial Statements

.25 In addition to the requirements in AU-C section 580, other AU-C sections require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor should request such other written representations.

.26 In addition to the required written representations previously discussed, the auditor may consider it necessary to request other written representations about the financial statements. Such written representations may supplement, but do not form part of, the written representations required by paragraphs .10–.18 of AU-C section 580, which are discussed in the preceding paragraphs. They may include representations about the following:

- Whether the selection and application of accounting policies are appropriate
- Whether matters such as the following, when relevant under the applicable financial reporting framework, have been recognized, measured, presented, or disclosed in accordance with that framework:
  - — Plans or intentions that may affect the carrying value or classification of assets and liabilities
  - — Liabilities, both actual and contingent
  - — Title to, or control over, assets and the liens or encumbrances on assets and assets pledged as collateral
- Aspects of laws, regulations, and contractual agreements that may affect the financial statements, including non-compliance

Exhibit B, "Illustrative Specific Written Representations," of AU-C section 580 contains illustrations of additional representations that may be appropriate in certain situations; it is reproduced in paragraph .53 of this section.

Additional Written Representations About Information Provided to the Auditor

.27 The auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.

Written Representations About Specific Assertions

.28 When obtaining evidence about or evaluating judgments and intentions, the auditor may consider one or more of the following:

- The entity's past history in carrying out its stated intentions
- The entity's reasons for choosing a particular course of action
- The entity's ability to pursue a specific course of action
- The existence, or lack thereof, of any other information obtained during the course of the audit that may be inconsistent with management's judgment or intent

.29 In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent regarding, or the completeness of, a specific assertion. For example, if the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

Materiality Considerations

.30 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Materiality may be different for different representations. A discussion of materiality may be included explicitly in the representation letter in either qualitative or quantitative terms. Materiality considerations do not apply to those representations that are not directly related to amounts included in the financial statements (for example, management's representations about the premise underlying the audit). In addition, because of the possible effects of fraud on other aspects of the audit, materiality would not apply to management's acknowledgment regarding its responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.

Form of, Date of, and Period(s) Covered by Written Representations

.31 The written representations should be in the form of a representation letter addressed to the auditor. Occasionally, circumstances may prevent management from signing the representation letter and returning it to the auditor on the date of the auditor's report. In those circumstances, the auditor may accept management's oral confirmation, on or before the date of the auditor's report, that management has reviewed the final representation letter and will sign the representation letter, without exception, as of the date of the auditor's report thereby providing sufficient appropriate audit evidence for the auditor to date the report. However, possession of the signed management representation letter prior to releasing the auditor's report is necessary because the representations are required to be in the form of a written letter from management (see paragraph .21 of AU-C section 580.) Furthermore, when there are delays in releasing the report, a fact may become known to the auditor that, had it been known to the auditor at the date of the auditor's report, might affect the auditor's report and result in the need for updated representations. AU-C section 560 addresses the auditor's responsibilities in such circumstances.

.32 The date of the written representations should be as of the date of the auditor's report on the financial statements. The written representations should be for all financial statements and period(s) referred to in the auditor's report. Because written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to, or disclosure in, the financial statements, the written representations are dated as of the date of the auditor's report on the financial statements.

.33 In some circumstances, it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. When this is the case, it may be necessary to request an updated written representation.

.34 The written representations cover all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

.35 Situations may arise in which current management was not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

Doubt About the Reliability of Written Representations

.36 If the auditor has concerns about the competence, integrity, ethical values, or diligence of management or about management's commitment to, or enforcement of, these, the auditor should determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general.

.37 Concerns about the competence, integrity, ethical values, or diligence of management or about its commitment to, or enforcement of, these may cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. In such a case, the auditor may consider withdrawing from the engagement, when withdrawal is possible under applicable law or regulation, unless those charged with governance put in place appropriate corrective measures. Such measures, however, may not be sufficient to enable the auditor to issue an unmodified audit opinion.

.38 If written representations are inconsistent with other audit evidence, the auditor should perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor should reconsider the assessment of the competence, integrity, ethical values, or diligence of management or of management's commitment to, or enforcement of, these and should determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general.

.39 In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, may revise the risk assessment and determine the nature, timing, and extent of further audit procedures to respond to the assessed risks.

.40 If the auditor concludes that the written representations are not reliable, the auditor should take appropriate action, including determining the possible effect on the opinion in the auditor's report in accordance with section AU-C section 705, considering the requirement in paragraph .25 of AU-C section 580, which is discussed in the following paragraph.

.41 The auditor should disclaim an opinion on the financial statements in accordance with AU-C section 705 or withdraw from the engagement if

- the auditor concludes that sufficient doubt exists about the integrity of management such that the written representations required by paragraphs .10–.11 of AU-C section 580 (discussed in paragraphs .10–.11 of this section) are not reliable or
- management does not provide the written representations required by paragraphs .10–.11 of AU-C section 580.

Scope Limitations

.42 If management does not provide one or more of the requested written representations, the auditor should

a. discuss the matter with management;

b. reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

c. take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with AU-C section 705, considering the requirement in paragraph .25 of AU-C section 580 (discussed in paragraph .41 of this section.)

.43 Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unmodified opinion and, in particular with respect to the representations in paragraphs .12–.18 of AU-C section 580 (discussed in paragraphs .12–.14, .16–.17, .20, and .23 of this section), may cause an auditor to disclaim an opinion or withdraw from the engagement when withdrawal is possible under applicable law or regulation. However, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate.

Communication With Those Charged With Governance

.44 Paragraph .14*d* of AU-C section 260 requires the auditor to communicate with those charged with governance the written representations that the auditor has requested from management. Additional discussion on AU-C section 260 is provided in section 7500, "Communication With Management and Those Charged With Governance."

Illustrative Representation Letter—Audit of Financial Statements

.45 The following illustrative letter includes written representation that are required by AU-C section 580 and other AU-C sections in effect for audits of financial statements for periods ending on or after December 31, 2012. It is assumed in this illustration that the applicable financial reporting framework is accounting principles generally accepted in the United States of America, that the requirement in AU-C section 570 to obtain a written representation is not relevant, and that no exceptions exist to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

.46 Illustrative Representation Letter

[*Prepared on Client's Letterhead*]

[*Date*]

To [*Independent Auditor*]

This representation letter is provided in connection with your audit of the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, for the purpose of expressing an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP).

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

Except where otherwise stated below, immaterial matters less than $[*insert amount*] collectively are not considered to be exceptions that require disclosure for the purpose of the following representations. This amount is not necessarily indicative of amounts that would require adjustment to or disclosure in the financial statements.

We confirm that [*, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*] [*as of (date of auditor's report),*]:

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [*insert date*], for the preparation and fair presentation of the financial statements in accordance with U.S. GAAP.
- We acknowledge our responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
- We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of U.S. GAAP.
- All events subsequent to the date of the financial statements and for which U.S. GAAP requires adjustment or disclosure have been adjusted or disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.
- The effects of all known actual or possible litigation and claims have been accounted for and disclosed in accordance with U.S. GAAP.

[*Any other matters that the auditor may consider appropriate pursuant to paragraph .A21* of AU-C section 580 (see paragraph .29).]

Information Provided

- We have provided you with:
  - — Access to all information, of which we are aware that is relevant to the preparation and fair presentation of the financial statements such as records, documentation, and other matters;
  - — Additional information that you have requested from us for the purpose of the audit; and
  - — Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We have [*no knowledge of any*] [*disclosed to you all information that we are aware of regarding*] fraud or suspected fraud that affects the entity and involves:
  - — Management;
  - — Employees who have significant roles in internal control; or
  - — Others when the fraud could have a material effect on the financial statements.
- We have [*no knowledge of any*] [*disclosed to you all information that we are aware of regarding*] allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators, or others.
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.
- We [*have disclosed to you all known actual or possible*] [*are not aware of any pending or threatened*] litigation, claims, and assessments whose effects should be considered when preparing the financial statements [*and we have not consulted legal counsel concerning litigation, claims, or assessments*].
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.

[*Any other matters that the auditor may consider appropriate pursuant to paragraph .A21* of AU-C section 580 (see paragraph .29).]

____

[*Name of Chief Executive Officer and Title*]

____

[*Name of Chief Financial Officer and Title*]

.47 Short Form Representation Letter for a Review of Interim Financial Information

> ***Note:*** This representation letter is to be used in conjunction with the representation letter for the audit of the financial statements of the prior year. Management confirms the representations made in the representation letter for the audit of the financial statements of the prior year end, as they apply to the interim financial information, and makes additional representations that may be needed for the interim financial information. Paragraphs .21–.22 and .A29–.A32 of AU-C section 930 establish requirements and provide guidance, respectively, regarding obtaining written representations from management when engaged to review interim financial information under the conditions specified in AU-C section 930.

[*Prepared on Client's Letterhead*]

[*Date*]

To [*Independent Auditor*]:

This representation letter is provided in connection with your review of the [*consolidated*] balance sheet as of June 30, 20X1 and the related [*consolidated*] statements of income, changes in equity, and cash flows for the six-month period then ended of ABC Company for the purpose of reporting whether any material modifications should be made to the [*consolidated*] interim financial information for it to be in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) [*including, if appropriate, an indication as to the appropriate form and content of interim financial information (for example, Article 10 of SEC Regulation S-X)*].

We confirm that [*, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*] [*as of (date of auditor's review report),*]:

Interim Financial Information

1. We have fulfilled our responsibilities, as set out in the terms of the engagement letter dated [*insert date*] for the preparation and fair presentation of interim financial information in accordance with U.S. GAAP; in particular the interim financial information is presented in accordance therewith.

2. We acknowledge our responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of interim financial information that is free from material misstatement, whether due to fraud or error.

3. The interim financial information has been adjusted or includes disclosures for all events subsequent to the date of the interim financial information for which U.S. GAAP requires adjustment or disclosure.

4. The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the interim financial information as a whole. A list of the uncorrected misstatements is attached to the representation letter.
   [*Any other matters that the auditor may consider appropriate*]

Information Provided

5. We have provided you with:
   - Access to all information of which we are aware that is relevant to the preparation and fair presentation of the interim financial information such as records, documentation, and other matters;
   - Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared;

- Additional information that you have requested from us for the purpose of the review; and
- Unrestricted access to persons within the entity of whom you determined it necessary to make inquiries.

6. We have disclosed to you all significant deficiencies or material weaknesses in the design or operation of internal control of which we are aware, as it relates to the preparation and fair presentation of both annual and interim financial information.

7. We have disclosed to you the results of our assessment of the risk that the interim financial information may be materially misstated as a result of fraud.

8. We have [*no knowledge of any*] [*disclosed to you all information of which we are aware in relation to*] fraud or suspected fraud that affects the entity and involves:
   - Management;
   - Employees who have significant roles in internal control; or
   - Others when the fraud could have a material effect on the interim financial information.

9. We have [*no knowledge of any*] [*disclosed to you all information in relation to*] allegations of fraud, or suspected fraud, affecting the entity's interim financial information communicated by employees, former employees, analysts, regulators, or others.

10. We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.
    [*Any other matters that the auditor may consider necessary*]

11. We have reviewed our representation letter to you dated [*date of representation letter relating to most recent audit*] with respect to the audited [*consolidated*] financial statements as of and for the year ended [*prior year-end date*]. We believe that representations [*references to applicable representations*] within that representation letter do not apply to the interim financial information referred to above. We now confirm those representations [*references to applicable representations*], as they apply to the interim financial information referred to above, and incorporate them herein, with the following changes: [*Indicate any changes.*]

12. [*Add any representations related to new accounting or auditing standards that are being implemented for the first time*.]

____

[*Name of Chief Executive Officer and Title*]

____

[*Name of Chief Financial Officer and Title*]

____

[*Name of Chief Accounting Officer and Title*]

.48 Detailed Representation Letter for a Review of Interim Financial Information

> ***Note:*** This representation letter is similar in detail to the management representation letter used for the audit of the financial statements of the prior year and, thus, need not refer to the written management representations received in the most recent audit. Paragraphs .21–.22 and .A29–.A32 of AU-C section 930 establish requirements and provide guidance, respectively, regarding obtaining written representations from management when engaged to review interim financial information under the conditions specified in AU-C section 930.

[*Prepared on Client's Letterhead*]

[*Date*]

To [*Independent Auditor*]:

This representation letter is provided in connection with your review of the [*consolidated*] balance sheet as of June 30, 20X1 and the related [*consolidated*] statements of income, changes in equity, and cash flows for the six-month period then ended of ABC Company for the purpose of reporting whether any material modifications should be made to the [*consolidated*] interim financial information for it to be in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) [*including, if appropriate, an indication as to the appropriate form and content of interim financial information (for example, Article 10 of SEC Regulation S-X)*].

We confirm that [*, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*] [*as of (date of auditor's review report),*]:

Interim Financial Information

1. We have fulfilled our responsibilities, as set out in the terms of the engagement letter dated [*insert date*] for the preparation and fair presentation of the interim financial information in accordance with U.S. GAAP; in particular the interim financial information is presented in accordance therewith.
2. We acknowledge our responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of interim financial information that is free from material misstatement, whether due to fraud or error.
3. Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
4. Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of U.S. GAAP.
5. The interim financial information has been adjusted or includes disclosures for all events subsequent to the date of the interim financial information for which U.S. GAAP requires adjustment or disclosure.
6. The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the interim financial information as a whole. A list of the uncorrected misstatements is attached to the representation letter.
   [*Any other matters that the auditor may consider appropriate*]

Information Provided

7. We have provided you with:
   - Access to all information of which we are aware that is relevant to the preparation and fair presentation of the interim financial information such as records, documentation, and other matters;

- Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared;
- Additional information that you have requested from us for the purpose of the review; and
- Unrestricted access to persons within the entity of whom you determined it necessary to make inquiries.

8. All transactions have been recorded in the accounting records and are reflected in the interim financial information.
9. We have disclosed to you all significant deficiencies or material weaknesses in the design or operation of internal control of which we are aware, as it relates to the preparation and fair presentation of both annual and interim financial information.
10. We have disclosed to you the results of our assessment of the risk that the interim financial information may be materially misstated as a result of fraud.
11. We have [*no knowledge of any*][*disclosed to you all information of which we are aware in relation to*] fraud or suspected fraud that affects the entity and involves:
    - Management;
    - Employees who have significant roles in internal control; or
    - Others when the fraud could have a material effect on the interim financial information.
12. We have [*no knowledge of any*][*disclosed to you all information in relation to*] allegations of fraud, or suspected fraud, affecting the entity's interim financial information communicated by employees, former employees, analysts, regulators, or others.
13. We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing interim financial information.
14. There have been no communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.
15. We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.

[*Any other matters that the auditor may consider necessary*]

____

[*Name of Chief Executive Officer and Title*]

____

[*Name of Chief Financial Officer and Title*]

____

[*Name of Chief Accounting Officer and Title*]

.49 Illustrative Representation Letter—Audit of Personal Financial Statements

[*Date*]

[*To the Independent Auditor*]

This letter is provided in connection with your audit of the personal financial statements of James and Jane Person, which comprise the statement of financial condition as of December 31, 20X1, and the related statement of changes in net worth for the year then ended, and the related notes to the financial statements, for the purpose of expressing an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

Except where otherwise stated below, immaterial matters less than $[*insert amount*] collectively are not considered to be exceptions that require disclosure for the purpose of the following representations. This amount is not necessarily indicative of amounts that would require adjustment to or disclosure in the financial statements.

We confirm that [*, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*] [*as of (date of auditor's report),*]:

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [*insert date*], for the preparation and fair presentation of the financial statements in accordance with U.S. GAAP.
- We acknowledge our responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.[2]
- We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of U.S. GAAP.
- All events subsequent to the date of the financial statements and for which U.S. GAAP requires adjustment or disclosure have been adjusted or disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.

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[2] Internal control over financial reporting includes the design and implementation of those policies and procedures deemed necessary to provide reasonable assurance that financial statements are fairly presented in accordance with the applicable financial reporting framework.

Although an individual typically does not have a formal system of internal control over financial reporting, an individual usually has some controls that provide for the preparation of his or her financial statements. For example, an individual usually has controls sufficient for him or her to identify amounts of assets owned and liabilities owed. Regardless of the formality of controls, an individual is still responsible for having those controls in place that allow for the preparation of his or her personal financial statements in accordance with the applicable financial reporting framework.

Auditor's may be engaged to perform certain nonattest services whereby the auditor designs, implements, or maintains certain aspects of an individual's internal control. The auditor should be aware that the performance of these services may impair the auditor's independence. An auditor is required to be independent to perform an audit engagement. In making a judgment about whether he or she is independent, the auditor should be guided by the AICPA Code of Professional Conduct.

The auditor is required to disclose in the auditor's report management's acknowledgment of its responsibility for internal control over financial reporting and the auditor's requirement to disclose such responsibility.

- The effects of all known actual or possible litigation, claims, and assessments have been accounted for and disclosed in accordance with U.S. GAAP.

[*Any other matters that the auditor may consider appropriate pursuant to paragraph .A21* of AU-C section 580 (see paragraph .29).]

Information Provided

- We have provided you with:
  - Access to all information, of which we are aware that is relevant to the preparation and fair presentation of the financial statements such as records, documentation, and other matters;
  - Additional information that you have requested from us for the purpose of the audit; and
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We have [*no knowledge of any*] [*disclosed to you all information that we are aware of regarding*] fraud or suspected fraud that affects us and involves:
  - Us; or
  - Others when the fraud could have a material effect on the financial statements
- We have [*no knowledge of any*] [*disclosed to you all information that we are aware of regarding*] allegations of fraud, or suspected fraud, affecting us communicated by analysts, regulators, short sellers, or others.
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.
- We [*have disclosed to you all known actual or possible*] [*are not aware of any pending or threatened*] litigation, claims, and assessments whose effects should be considered when preparing the financial statements [*and we have not consulted legal counsel concerning litigation, claims, or assessments*].
- We have disclosed to you the identity of related parties and all the related party relationships and transactions of which we are aware.

[*Any other matters that the auditor may consider appropriate pursuant to paragraph .A21* of AU-C section 580 (see paragraph .29).]

____
(James Person)

____
(Jane Person)

.50 Illustrative Representation Letter to Other Accountants

> ***Note:*** If any matters come to the firm's attention that may require revision of the previous financial statements, they could be included in a separate paragraph after approval by the engagement partner.

[*Firm's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

In connection with the report you have been requested to reissue on the financial statements of [*client's name*] for the year ended [*date*], which statements are to be included comparatively with similar statements for the year ended [*date*], we make the following representations.

We have audited (or reviewed or compiled) the balance sheet of [*client's name*] as of [*balance sheet date*] and the related statements of earnings, retained earnings, and cash flows for the year then ended. Our procedures in connection with the engagement did not disclose any events or transactions subsequent to [*predecessor's balance sheet date*] which, in our opinion, would have a material effect upon the financial statements, or which would require mention in the notes to the financial statements of [*client's name*] for the year then ended.

Should anything come to our attention prior to the date our report is issued that, in our judgment, would have a material effect upon the financial statements covered by your report, we shall notify you promptly.

Sincerely,

____

[*Engagement Partner's Signature*]

.51 Letter to Other Accountants Upon Whose Work We Plan to Rely

[*Firm's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

We are auditing the financial statements of [*client's name*], [*parent company*]. The financial statements of [*other accountants' client's name*] that you are auditing are to be included in the financial statements of [*client's name*]. We will rely on your report on the financial statements in expressing an opinion on the [*consolidated*] financial statements of [*client's name*] (and subsidiaries). In that connection, we will refer to your report.

Please confirm to us that your firm is independent with respect to [*client's name*] and [*other accountant's client's name*] within the meaning of Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .01), of the Code of Professional Conduct.

Please provide us promptly, in writing, with the following information in connection with your current examination of the financial statements of [*other accountant's client's name*] with respect to the following:

1. Related party transactions or other matters that have come to your attention. We are aware of the following related parties: [*names of known related parties*].
2. Any limitation on the scope of your examination that is related to the financial statements of [*client's name*], or that limits your ability to respond to this inquiry.

Please update your letter to indicate any additional matters of the type designated above that have come to your attention through the date of your report on the financial statements of [*other accountants' client's name*].

We have identified the following significant risks of material misstatement of the financial statements of [*client's name*], [*parent company*] due to error or fraud that are relevant to your audit of the financial statements of [*other accountants' client's name*]:

[*Describe the identified significant risks of material misstatement of the group financial statements, due to error or fraud that are relevant to the work of the component auditor*]

Sincerely,

____

[*Engagement Partner's Signature*]

.52 Illustrative Updating Management Representation Letter

The following letter is presented for illustrative purposes only. It may be used in the circumstances described in paragraph .A17 of AU-C section 580. Management need not repeat all of the representations made in the previous representation letter.

If matters to be disclosed to the auditor exist, they may be listed following the representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred . . ."

[*Firm's Letterhead*]

[*Date*]

To [*Auditor*],

In connection with your audit(s) of the [*identification of financial statements*] of [*name of entity*] as of [*dates*] and for the [*periods*] for the purpose of expressing an opinion as to whether the [*consolidated*] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [*name of entity*] in conformity with accounting principles generally accepted in the United States of America, you were previously provided with a representation letter under date of [*date of previous representation letter*]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [*date of latest balance sheet reported on by the auditor*] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____

[*Name of Chief Executive Officer and Title*]

____

[*Name of Chief Financial Officer and Title*]

Illustrative Specific Written Representations

.53 The auditor may determine that a specific written representation is necessary to corroborate other audit evidence. Certain AICPA Audit and Accounting Guides recommend that the auditor obtain written representations concerning matters that are unique to a particular industry. The following is a list of additional representations that may be appropriate in certain situations. This list is not intended to be all-inclusive. The existence of a condition listed subsequently does not mean that the representation is required; professional judgment is necessary to determine whether corroborative audit evidence in the form of a specific written representation is necessary.

Condition	*Illustrative Specific Written Representation*
General	
Unaudited interim information accompanies the financial statements.	The unaudited interim financial information accompanying [*presented in Note X to*] the financial statements for the [*identify all related periods*] has been prepared and fairly presented in conformity with generally accepted accounting principles applicable to interim financial information. The accounting principles used to prepare the unaudited interim financial information are consistent with those used to prepare the audited financial statements.
The effect of a new accounting principle is not known.	We have not completed the process of evaluating the effect that will result from adopting the guidance in Financial Accounting Standards Board (FASB) Accounting Standards Update 20YY-XX, as discussed in Note [*X*]. The company is therefore unable to disclose the effect that adopting the guidance in FASB Accounting Standards Update 20YY-XX will have on its financial position and the results of operations when such guidance is adopted.
Financial circumstances are strained, with disclosure of management's intentions and the entity's ability to continue as a going concern.	Note [*X*] to the financial statements discloses all of the matters of which we are aware that are relevant to the company's ability to continue as a going concern, including significant conditions and events, and management's plans.
The possibility exists that the value of specific significant long-lived assets or certain identifiable intangibles may be impaired.	We have reviewed long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances have indicated that the carrying amount of the assets might not be recoverable and have appropriately recorded the adjustment.

Condition	*Illustrative Specific Written Representation*
The entity has a variable interest in another entity.	Variable interest entities (VIEs) and potential VIEs and transactions with VIEs and potential VIEs have been properly recorded and disclosed in the financial statements in accordance with generally accepted accounting principles. We have considered both implicit and explicit variable interests in (*a*) determining whether potential VIEs should be considered VIEs, (*b*) calculating expected losses and residual returns, and (*c*) determining which party, if any, is the primary beneficiary. We have provided you with lists of all identified variable interests in (i) VIEs, (ii) potential VIEs that we considered but judged not to be VIEs, and (iii) entities that were afforded the scope exceptions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification*® (ASC) 810, *Consolidation*. We have advised you of all transactions with identified VIEs, potential VIEs, or entities afforded the scope exceptions of FASB ASC 810. We have made available all relevant information about financial interests and contractual arrangements with related parties, de facto agents and other entities, including but not limited to, their governing documents, equity and debt instruments, contracts, leases, guarantee arrangements, and other financial contracts and arrangements. The information we provided about financial interests and contractual arrangements with related parties, de facto agents and other entities includes information about all transactions, unwritten understandings, agreement modifications, and written and oral side agreements. Our computations of expected losses and expected residual returns of entities that are VIEs and potential VIEs are based on the best information available and include all reasonably possible outcomes. Regarding entities in which the company has variable interests (implicit and explicit), we have provided all information about events and changes in circumstances that could potentially cause reconsideration about whether the entities are VIEs or whether the company is the primary beneficiary or has a significant variable interest in the entity. We have made and continue to make exhaustive efforts to obtain information about entities in which the company has an implicit or explicit interest but that were excluded from complete analysis under FASB ASC 810 due to lack of essential information to determine one or more of the following: whether the entity is a VIE, whether the company is the primary beneficiary, or the accounting required to consolidate the entity.
The work of a specialist has been used by the entity.	We agree with the findings of specialists in evaluating the [*describe assertion*] and have adequately considered the qualifications of the specialist in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to specialists with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an effect on the independence or objectivity of the specialists.

(continued)

Condition	*Illustrative Specific Written Representation*
Assets	
Cash Disclosure is required of compensating balances or other arrangements involving restrictions on cash balances, lines of credit, or similar arrangements.	Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances, line of credit, or similar arrangements have been properly disclosed.
Financial Instruments Management intends to and has the ability to hold to maturity debt securities classified as held-to-maturity.	Debt securities that have been classified as held-to-maturity have been so classified due to the company's intent to hold such securities, to maturity and the company's ability to do so. All other debt securities have been classified as available-for-sale or trading.
Management considers the decline in value of debt or equity securities to be temporary.	We consider the decline in value of debt or equity securities classified as either available-for-sale or held-to-maturity to be temporary.
Management has determined the fair value of significant financial instruments that do not have readily determinable fair values.	The methods and significant assumptions used to determine fair values of financial instruments are as follows: [*describe methods and significant assumptions used to determine fair values of financial instruments*]. The methods and significant assumptions used result in a measure of fair value appropriate for financial statement measurement and disclosure purposes.
Financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk exist.	The following information about financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk has been properly disclosed in the financial statements: 1. The extent, nature, and terms of financial instruments with off-balance-sheet risk 2. The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments 3. Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments
Investments Unusual considerations are involved in determining the application of equity accounting.	[*For investments in common stock that are either nonmarketable or of which the entity has a 20 percent or greater ownership interest, select the appropriate representation from the following:*] • The equity method is used to account for the company's investment in the common stock of [*investee*] because the company has the ability to exercise significant influence over the investee's operating and financial policies. • The cost method is used to account for the company's investment in the common stock of [*investee*] because the company does not have the ability to exercise significant influence over the investee's operating and financial policies.
The entity had loans to executive officers, non-accrued loans or zero interest rate loans.	Loans to executive officers have been properly accounted for and disclosed.

Condition	*Illustrative Specific Written Representation*
Liabilities	
Debt Short-term debt could be refinanced on a long-term basis and management intends to do so.	The company has excluded short-term obligations totaling $[*amount*] from current liabilities because it intends to refinance the obligations on a long-term basis. [*Complete with appropriate wording detailing how amounts will be refinanced as follows:*] • The company has issued a long-term obligation [*debt security*] after the date of the balance sheet but prior to the issuance of the financial statements for the purpose of refinancing the short-term obligations on a long-term basis. • The company has the ability to consummate the refinancing, by using the financing agreement referred to in Note [*X*] to the financial statements.
Tax-exempt bonds have been issued.	Tax-exempt bonds issued have retained their tax-exempt status.
Taxes Management intends to reinvest undistributed earnings of a foreign subsidiary.	We intend to reinvest the undistributed earnings of [*name of foreign subsidiary*].
Pension and Postretirement Benefits An actuary has been used to measure pension liabilities and costs.	We believe that the actuarial assumptions and methods used to measure pension liabilities and costs for financial accounting purposes are appropriate in the circumstances.
Involvement with a multiemployer plan exists.	We are unable to determine the possibility of a withdrawal liability in a multiemployer benefit plan. or We have determined that there is the possibility of a withdrawal liability in a multiemployer plan in the amount of $[*XX*].
Postretirement benefits have been eliminated.	We do not intend to compensate for the elimination of postretirement benefits by granting an increase in pension benefits. or We plan to compensate for the elimination of postretirement benefits by granting an increase in pension benefits in the amount of $[*XX*].
Employee layoffs that would otherwise lead to a curtailment of a benefit plan are intended to be temporary.	Current employee layoffs are intended to be temporary.
Management intends to either continue to make or not make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost, or has expressed a substantive commitment to increase benefit obligations.	We plan to continue to make frequent amendments to the pension or other postretirement benefit plans, which may affect the amortization period of prior service cost. or We do not plan to make frequent amendments to the pension or other postretirement benefit plans.

(continued)

Condition	*Illustrative Specific Written Representation*
Equity	
Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements exist.	Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements have been properly disclosed.

[*The next page is 7501.*]

AAM Section 7500

Communication With Management and Those Charged With Governance

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 210, *Terms of Engagement*
- AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- AU-C section 260, *The Auditor's Communication With Those Charged With Governance*
- AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- AU-C section 320, *Materiality in Planning and Performing an Audit*
- AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
- AU-C section 550, *Related Parties*
- AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*
- AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*
- AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*
- AU-C section 730, *Required Supplementary Information*
- AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication*
- AU-C section 930, *Interim Financial Information*
- AU-C section 935, *Compliance Audits*

.01 AU-C section 260 establishes standards and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although AU-C section 260 applies regardless of an entity's governance structure or size, particular considerations apply when all of those charged with governance are involved in managing an entity. AU-C section 260 does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.

.02 The term *those charged with governance* means the person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel; for example, executive members of a governance board or an owner-manager.

.03 Recognizing the importance of effective two-way communication to the audit, AU-C section 260 provides an overarching framework for the auditor's communication with those charged with governance and identifies some specific matters to be communicated. Additional matters to be communicated are identified in other AU-C sections. In addition, AU-C section 265 establishes specific requirements regarding the communication of significant deficiencies and material weaknesses in internal control the auditor has identified during the audit to those charged with governance. Further matters not required by generally accepted auditing standards (GAAS) may be required to be communicated by agreement with those charged with governance or management or in accordance with external requirements. Nothing in this section precludes the auditor from communicating any other matters to those charged with governance.

Those Charged With Governance

.04 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate.

.05 Governance structures vary by entity, reflecting influences such as size and ownership characteristics. For example,

- in some entities, those charged with governance hold positions (for example, company directors) that are integral parts of the entity's legal structure. For other entities, a body that is not part of the entity is charged with governance, as with some government agencies.
- in some cases, some or all of those charged with governance also have management responsibilities. In others, those charged with governance and management are different people.
- parties charged with governance of governmental entities may include members or staff of a legislative oversight committee, oversight bodies, or other parties contracting for the audit.

.06 In most entities, governance is the collective responsibility of a governing body, such as a board of directors; a supervisory board; partners; proprietors; a committee of management; trustees; or equivalent persons. In some smaller entities, however, one person may be charged with governance, such as the owner-manager, when there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup, such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities.

.07 Such diversity means that it is not possible for this section to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances. An example of this is entities in which the governance structures are not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. When the appropriate person(s) with whom to communicate is not clearly identifiable, the auditor and the engaging party may need to discuss and agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained, in accordance with AU-C section 315 is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

.08 Paragraphs .46–.49 of AU-C section 600 include specific matters to be communicated by group auditors with those charged with governance. When the entity being audited is a component of a group, the appropriate person(s) with whom to communicate is dependent on the nature of the matter to be communicated and the terms of the engagement.

Communication With the Audit Committee or Other Subgroup of Those Charged With Governance

.09 If the auditor communicates with a subgroup of those charged with governance, such as the audit committee or an individual, the auditor should determine whether the auditor also needs to communicate with the governing body.

.10 When considering communicating with a subgroup of those charged with governance, the auditor may take into account matters such as

- the respective responsibilities of the subgroup and the governing body.
- the nature of the matter to be communicated.
- relevant legal or regulatory requirements.
- whether the subgroup (*a*) has the authority to take action regarding the information communicated and (*b*) can provide further information and explanations the auditor may need.
- whether the auditor is aware of potential conflicts of interest between the subgroup and other members of the governing body.

.11 When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in the terms of the engagement that the auditor retains the right to communicate directly with the governing body.

.12 Audit committees (or similar subgroups with different names) exist in many entities. Although the specific authority and functions of audit committees may differ, communication with the audit committee, when one exists, is a key element in the auditor's communication with those charged with governance. Good governance principles suggest that

- the auditor has access to the audit committee as necessary.
- the chair of the audit committee and, when relevant, the other members of the audit committee meet with the auditor periodically.
- the audit committee meets with the auditor without management present at least annually, unless prohibited by law or regulation.

When All of Those Charged With Governance Are Involved in Managing the Entity

.13 In some cases, all of those charged with governance are involved in managing the entity; for example, a small business in which a single owner manages the entity and no one else has a governance role. In these cases, if matters required by AU-C section 260 are communicated with a person(s) with management responsibilities and that person(s) also has governance responsibilities, the matters need not be communicated again with the same person(s) in that person's governance role. These matters are noted in paragraph .14 of AU-C section 260 (discussed in paragraph .19 of this section). The auditor should, nonetheless, be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.

Matters to Be Communicated

The Auditor's Responsibilities With Regard to the Financial Statement Audit

.14 The auditor should communicate with those charged with governance the auditor's responsibilities with regard to the financial statement audit, including that:

- the auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of those charged with governance are prepared, in all material respects, in conformity with the applicable financial reporting framework.
- the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

These responsibilities may be communicated through the engagement letter, or other suitable form of written agreement that documents the terms of the engagement, if the engagement letter or other written agreement is provided to those charged with governance. Paragraphs .A13–.A17 of AU-C section 260 provide additional guidance regarding communicating with those charged with governance about the planned scope and timing of the audit.

Planned Scope and Timing of the Audit

.15 The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit.

.16 Care is required when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly when some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable. Certain factors described in paragraph .A39 of AU-C section 260 may be relevant in determining the nature and extent of this communication.

.17 Communication regarding the planned scope and timing of the audit may assist

- those charged with governance to discuss issues of risk and materiality with the auditor;
- those charged with governance to understand better the consequences of the auditor's work and to identify any areas in which they may request the auditor to undertake additional procedures; and
- the auditor to understand better the entity and its environment.

.18 Matters communicated may include the following:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error
- The auditor's approach to internal control relevant to the audit including, when applicable, whether the auditor will express an opinion on the effectiveness of internal control over financial reporting
- The application of materiality in the context of an audit, as discussed in AU-C section 320
- If the entity has an internal audit function, the extent to which the auditor will use the work of internal audit and how the external and internal auditors can best work together

.19 Other planning matters that may be appropriate to discuss with those charged with governance include

- the views of those charged with governance about the following matters:
    - — The appropriate person(s) in the entity's governance structure with whom to communicate
    - — The allocation of responsibilities between those charged with governance and management
    - — The entity's objectives and strategies and the related business risks that may result in material misstatements
    - — Matters those charged with governance consider as warranting particular attention during the audit and any areas for which they request additional procedures to be undertaken
    - — Significant communications with regulators

- Other matters those charged with governance believe are relevant to the audit of the financial statements

- the attitudes, awareness, and actions of those charged with governance concerning (*a*) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (*b*) the detection or the possibility of fraud.
- the actions of those charged with governance in response to developments in law, accounting standards, corporate governance practices, and other related matters.
- the actions of those charged with governance in response to previous communications with the auditor.

.20 Although communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing, and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Significant Findings or Issues From the Audit

.21 The auditor should communicate with those charged with governance

- the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures. When applicable, the auditor should
  - explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity and
  - determine that those charged with governance are informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.
    - Paragraphs .A24–.A25 and the appendix, "Qualitative Aspects of Accounting Practices," of AU-C section 260 provide additional guidance regarding communicating with those charged with governance about the auditor's the qualitative aspects of the entity's significant accounting practices.
- significant difficulties, if any, encountered during the audit (see paragraph .A26 of AU-C section 260 for additional discussion of this topic);
- disagreements with management, if any (see paragraph .A28 of AU-C section 260 for additional discussion of this topic); and
- other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process (see paragraph .A27 of AU-C section 260 for additional discussion of this topic).

.22 The communication of significant findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Qualitative Aspects of the Entity's Significant Accounting Practices

.23 Financial reporting frameworks ordinarily allow for the entity to make accounting estimates and judgments about accounting policies and financial statement disclosures. Open and constructive communication about qualitative aspects of the entity's significant accounting practices may include comment on the acceptability of significant accounting practices.

.24 Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. In communicating with those charged with governance about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates, the auditor may consider communicating

- the nature of significant assumptions,
- the degree of subjectivity involved in the development of the assumptions, and
- the relative materiality of the items being measured to the financial statements as a whole.

.25 The auditor's communication to those charged with governance may include such matters as the following:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, considering the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements (when acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant policies as well as information on accounting policies used by similar entities)
- The initial selection of, and changes in, significant accounting policies, including the application of new accounting pronouncements (the communication may include the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity, and the timing of a change in accounting policies with regard to expected new accounting pronouncements)
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative material or consensus)
- The effect of the timing of transactions in relation to the period in which they are recorded

Accounting Estimates

- For items for which estimates are significant, issues discussed in AU-C section 540, including the following examples:
  - — Management's identification of accounting estimates
  - — Management's process for making accounting estimates
  - — Risks of material misstatement
  - — Indicators of possible management bias
  - — Disclosure of estimation uncertainty in the financial statements

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (for example, disclosures related to revenue recognition, going concern, subsequent events, and contingency issues)
- The overall neutrality, consistency, and clarity of the disclosures in the financial statements

Related Matters

- The potential effect on the financial statements of significant risks and exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements
- The extent to which the financial statements are affected by unusual transactions, including nonrecurring amounts recognized during the period, and the extent to which such transactions are separately disclosed in the financial statements
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets (the communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements
- The selective correction of misstatements (for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings)

Significant Difficulties Encountered During the Audit

.26 Significant difficulties encountered during the audit may include matters such as

- significant delays in management providing required information.
- an unnecessarily brief time within which to complete the audit.
- extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- the unavailability of expected information.
- restrictions imposed on the auditor by management.
- management's unwillingness to provide information about management's plans for dealing with the adverse effects of the conditions or events that lead the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

Other Findings or Issues

.27 The auditor may become aware that the entity is subject to an audit requirement that is not encompassed in the terms of the engagement. The communication to those charged with governance that an audit conducted in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements may be necessary if, for example, an entity engages an auditor to perform an audit of its financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement the entity also is required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*
- OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

Disagreements With Management

.28 Discussions with those charged with governance include any disagreements with management that arose during the audit, regardless of whether they were satisfactorily resolved, about matters that, individually or in the aggregate, could be significant to the entity's financial statements or the auditor's report. Disagreements with management may occasionally arise over, among other things, the application of accounting principles to the entity's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the entity's financial statements, and the wording of the auditor's report. For purposes of this section, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

Uncorrected Misstatements

.29 The auditor should communicate with those charged with governance

- uncorrected misstatements accumulated by the auditor and the effect that they, individually or in the aggregate, may have on the opinion in the auditor's report. The auditor's communication should identify material uncorrected misstatements individually. The auditor should request that uncorrected misstatements be corrected.
- the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

.30 The auditor is not required to accumulate misstatements that the auditor believes are trivial. When there are a large number of individually immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

.31 The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, taking into account the size and nature of the misstatement judged in the surrounding circumstances, and possible implications with regard to future financial statements.

When Not All of Those Charged With Governance Are Involved in Management

.32 Unless all of those charged with governance are involved in managing the entity, the auditor also should communicate the following:

- Material, corrected misstatements that were brought to the attention of management as a result of audit procedures. The auditor also may communicate other corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.
- Significant findings or issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management. Significant findings or issues discussed, or the subject of correspondence, with management may include matters such as
    - — business conditions affecting the entity and business plans and strategies that may affect the risks of material misstatement.
    - — discussions or correspondence in connection with the initial or recurring engagement of the auditor including, among other matters, any discussions or correspondence regarding accounting practices or the application of auditing standards.
- The auditor's views about significant matters that were the subject of management's consultations with other accountants on accounting or auditing matters when the auditor is aware that such consultation has occurred.
- Written representations the auditor is requesting. The auditor may provide those charged with governance with a copy of management's written representations.

Establishing the Communication Process

.33 The auditor should communicate with those charged with governance the form, timing, and expected general content of communications. Clear communication of the following helps establish the basis for effective two-way communication:

- The auditor's responsibilities
- An overview of the planned scope and timing of the audit
- The expected general content of communications

.34 Matters that may also contribute to effective two-way communication include discussion of the following:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are in a better position to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) on the audit team and among those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit. Such matters might include strategic decisions that may significantly affect the nature, timing, and extent of audit procedures; the suspicion or the detection of fraud; or concerns about the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

.35 The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit

Forms of Communication

.36 The auditor should communicate in writing with those charged with governance significant findings or issues from the audit (see paragraphs .12–.14 of AU-C section 260 [discussed in paragraphs .21, .29, and .32 of this section]) if, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved.

.37 Effective communication may involve formal presentations and written reports as well as less formal communications, including discussions. The auditor may communicate matters other than those identified in paragraph .16 of AU-C section 260 (discussed in the preceding paragraph) either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

.38 In addition to the significance of a particular matter, the form of communication (for example, whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a formal or informal manner) may be affected by factors such as

- whether the matter has been satisfactorily resolved.
- whether management has previously communicated the matter.

- the size, operating structure, control environment, and legal structure of the entity being audited.
- legal or regulatory requirements that may require a written communication with those charged with governance.
- the expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- the amount of ongoing contact and dialogue the auditor has with those charged with governance.
- whether there have been significant changes in the membership of a governing body.
- in the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.

.39 When a significant matter is discussed with an individual member of those charged with governance, such as the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

Restricted Use

.40 When the auditor communicates matters in accordance with AU-C section 260 in writing, the communication is considered a by-product report. Accordingly, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management; and is not intended to be and should not be used by anyone other than these specified parties.

Timing of Communications

.41 The auditor should communicate with those charged with governance on a timely basis. The appropriate timing for communications will vary with the circumstances of the engagement. Considerations include the significance and nature of the matter and the action expected to be taken by those charged with governance. The auditor may consider communicating

- planning matters early in the audit engagement and, for an initial engagement, as part of the terms of the engagement.
- significant difficulties encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor in overcoming the difficulties or if the difficulties are likely to lead to a modified opinion.

.42 Other factors that may be relevant to the timing of communications include

- the size, operating structure, control environment, and legal structure of the entity being audited.
- any legal obligation to communicate certain matters within a specified timeframe.
- the expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- the time at which the auditor identifies certain matters (for example, timely communication of a material weakness to enable appropriate remedial action to be taken).
- whether the auditor is auditing both general purpose and special purpose financial statements.

Adequacy of the Communication Process

.43 The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor should evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence and should take appropriate action.

.44 The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance. Rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include

- the appropriateness and timeliness of actions taken by those charged with governance in response to matters communicated by the auditor. When significant findings or issues raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire about why appropriate action has not been taken and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- the apparent openness of those charged with governance in their communications with the auditor.
- the willingness and capacity of those charged with governance to meet with the auditor without management present.
- the apparent ability of those charged with governance to fully comprehend matters raised by the auditor, such as the extent to which those charged with governance probe issues and question recommendations made to them.
- difficulty in establishing with those charged with governance a mutual understanding of the form, timing, and expected general content of communications.
- when all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities as well as their management responsibilities.

.45 As discussed in paragraph .A1 of AU-C section 260, effective two-way communication assists both the auditor and those charged with governance. Further, AU-C section 315 identifies participation by those charged with governance, including their interaction with internal auditors (if any) and external auditors, as an element of the entity's control environment. Inadequate two-way communication may indicate an unsatisfactory control environment, which will influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

.46 If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take actions such as the following:

- Modifying the auditor's opinion on the basis of a scope limitation
- Obtaining legal advice about the consequences of different courses of action
- Communicating with third parties (for example, a regulator) or a higher authority in the governance structure that is outside the entity, such as the owners of a business (for example, shareholders in a general meeting), or the responsible government agency for certain governmental entities
- Withdrawing from the engagement when withdrawal is possible under applicable law or regulation

Documentation

.47 When matters required to be communicated by this section have been communicated orally, the auditor should include them in the audit documentation, including when and to whom they were communicated. When matters have been communicated in writing, the auditor should retain a copy of the communication as part of the audit documentation.

.48 Documentation of oral communication may include a copy of minutes prepared by the entity as part of the audit documentation if those minutes are an appropriate record of the communication.

Additional Communication Requirements

.49 Requirements for the auditor to communicate with those charged with governance are included in other AU-C sections. AU-C section 260 does not change the AICPA professional standards requirements in the following:

a. paragraph .17 of AU-C section 210

b. paragraphs .21, .38*c*(i), and .39–.41 of AU-C section 240

c. paragraphs .14, .18, and .21–.23 of AU-C section 250

d. paragraph .11 of AU-C section 265 (discussed in paragraph .54 of this section.)

e. paragraph .27 of AU-C section 550

f. paragraphs .10*b*–*c*, .12*a*, .15*a*, .17*a*, and .18 of AU-C section 560

g. paragraphs .45–.48 of AU-C section 600

h. paragraphs .12, .14, .20, and .29 of AU-C section 705

i. paragraph .09 of AU-C section 706

j. paragraphs .08, .12, .15, and .18 of AU-C section 720

k. paragraph .06 of AU-C section 730

l. paragraphs .23–.28 of AU-C section 930

m. paragraphs .36–.37 of AU-C section 935

Communicating Internal Control Related Matters Identified in an Audit

.50 AU-C section 265 establishes requirements and provides guidance regarding the auditor's responsibility to appropriately communicate to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements.

Determination of Whether Deficiencies in Internal Control Have Been Identified

.51 The auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.

.52 In determining whether the auditor has identified one or more deficiencies in internal control, the auditor may discuss the relevant facts and circumstances of the auditor's findings with the appropriate level of management. This discussion provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the auditor to discuss the auditor's findings directly with management (for example, if the findings appear to call management's integrity or competence into question [see paragraph .A22 of AU-C section 265]).

.53 In discussing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as

- management's understanding of the actual or suspected causes of the deficiencies.
- exceptions arising from the deficiencies that management may have noted (for example, misstatements that were not prevented by the relevant IT controls).
- a preliminary indication from management of its response to the findings.

Considerations Specific to Smaller, Less Complex Entities

.54 Although the concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, the formality with which controls operate will vary. Further, smaller entities may find that certain types of control activities are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control activities.

.55 Also, smaller entities often have fewer employees, which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. On the other hand, such increased management oversight also may increase the risk of management override of controls.

Evaluating Identified Deficiencies in Internal Control

.56 If the auditor has identified one or more deficiencies in internal control, the auditor should evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies or material weaknesses.

.57 If the auditor determines that a deficiency, or a combination of deficiencies, in internal control is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion.

.58 The severity of a deficiency, or a combination of deficiencies, in internal control depends not only on whether a misstatement has actually occurred but also on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies and
- whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of an account balance or disclosure. A reasonable possibility exists when the chance of the future event or events occurring is more than remote.

Significant deficiencies and material weaknesses may exist even though the auditor has not identified misstatements during the audit.

.59 Factors that affect the magnitude of a misstatement that might result from a deficiency, or deficiencies, in internal control include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency

.60 In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount, whereas understatements could be larger.

.61 Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, in internal control will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, classes of transactions, disclosures, and assertions involved
- The cause and frequency of the exceptions detected as a result of the deficiency, or deficiencies, in internal control
- The susceptibility of the related asset or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control(s) with other controls
- The interaction with other deficiencies in internal control
- The possible future consequences of the deficiency, or deficiencies, in internal control
- The importance of the controls to the financial reporting process, including the following:
  - General monitoring controls (such as oversight of management)
  - Controls over the prevention and detection of fraud
  - Controls over the selection and application of significant accounting policies
  - Controls over significant transactions with related parties
  - Controls over significant transactions outside the entity's normal course of business
  - Controls over the period-end financial reporting process (such as controls over nonrecurring journal entries)

.62 The evaluation of whether a deficiency in internal control presents a reasonable possibility of misstatement may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

.63 Controls may be designed to operate individually, or in combination, to effectively prevent, or detect and correct, misstatements. For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency or a material weakness. However, a combination of deficiencies affecting the same significant account or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent to give rise to a significant deficiency or material weakness.

.64 Indicators of material weaknesses in internal control include

- identification of fraud, whether or not material, on the part of senior management;
- restatement of previously issued financial statements to reflect the correction of a material misstatement due to fraud or error;
- identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity's internal control; and
- ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

Communication of Deficiencies in Internal Control

Communication of Significant Deficiencies and Material Weaknesses to Those Charged With Governance

.65 The auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit.

.66 Communicating significant deficiencies and material weaknesses in writing to those charged with governance reflects the importance of these matters and assists those charged with governance in fulfilling their oversight responsibilities.

.67 The level of detail at which to communicate significant deficiencies and material weaknesses is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example, the following:

- The nature of the entity. For example, the communication required for a governmental entity may be different from that for a nongovernmental entity.
- The size and complexity of the entity. For example, the communication required for a complex entity may be different from that for an entity operating a simple business.
- The nature of significant deficiencies and material weaknesses that the auditor has identified.
- The entity's governance composition. For example, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.
- Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal control.

.68 Management and those charged with governance may already be aware of significant deficiencies and material weaknesses that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirements to communicate significant deficiencies and material weaknesses in paragraphs .11–.12 of AU-C section 265 (discussed in paragraphs .58 and .63, respectively) apply, regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

.69 The fact that the auditor communicated a significant deficiency or material weakness to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency or material weakness remains, the current year's communication may repeat the description from the previous communication or simply reference the previous communication and the date of that communication. The auditor may ask management or, when appropriate, those charged with governance why the significant deficiency or material weakness has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency or material weakness.

Communication of Significant Deficiencies and Material Weaknesses in Internal Control to Management

.70 The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis *a.* in writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.

b. in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

.71 Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies and material weaknesses, the appropriate level is likely to be the CEO or CFO (or equivalent) because these matters also are required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

.72 Certain identified significant deficiencies or material weaknesses in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management or management may exhibit an inability to oversee the preparation of adequate financial statements, which may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

.73 Paragraphs .21–.27 of AU-C section 250 establish requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such non-compliance. Paragraph .40 of AU-C section 240 establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management.

.74 *Communication of other deficiencies in internal control to management.* During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies or material weaknesses but that may be of sufficient importance to merit management's attention. The determination regarding which other deficiencies in internal control merit management's attention is a matter of the auditor's professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.

.75 The communication of other deficiencies in internal control that merit management's attention need not be in writing. When the auditor has discussed the facts and circumstances of the auditor's findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.

.76 If the auditor has communicated deficiencies in internal control, other than significant deficiencies or material weaknesses, to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor also is not required to repeat information about such deficiencies if the information has been previously communicated to management by other parties, such as internal auditors or regulators. However, the auditor may consider it appropriate to recommunicate these other deficiencies if there has been a change of management or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's professional judgment in the circumstances.

.77 In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control that the auditor has communicated to management or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may inform those charged with governance when a communication of other deficiencies has been made to management. In either case, the auditor may communicate orally or in writing to those charged with governance, as appropriate.

Timing of Communications to Management and Those Charged With Governance

.78 The communications referred to in paragraphs .11–.12 of AU-C section 265 (discussed in paragraphs .58 and .63, respectively) should be made no later than 60 days following the report release date.

.79 Although the auditor is required to make the communications referred to in paragraphs .11–.12 of AU-C section 265 (discussed in paragraphs .58 and .63, respectively) no later than 60 days following the report release date, the communication is best made by the report release date because receipt of such communication may be an important factor in enabling those charged with governance to discharge their oversight responsibilities. Nevertheless, because the auditor's written communication of significant deficiencies and material weaknesses forms part of the final audit file, the written communication is subject to the overriding requirement for the auditor to complete the assembly of the final audit file on a timely basis, no later than 60 days following the report release date.

.80 Early communication to those charged with governance or management may be important for some matters because of their relative significance and the urgency for corrective follow-up action. Regardless of the timing of the written communication of significant deficiencies and material weaknesses, the auditor may communicate these orally in the first instance to management and, when appropriate, those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. However, oral communication does not relieve the auditor of the responsibility to communicate the significant deficiencies and material weaknesses in writing, as required by AU-C section 265.

Content of Written Communication of Significant Deficiencies and Material Weaknesses in Internal Control

.81 The auditor should include in the auditor's written communication of significant deficiencies and material weaknesses

- the definition of the term *material weakness* and, when relevant, the definition of the term *significant deficiency*.
- a description of the significant deficiencies and material weaknesses and an explanation of their potential effects.
- sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor should include in the communication the following elements that explain that
  - — the purpose of the audit was for the auditor to express an opinion on the financial statements.
  - — the audit included consideration of internal control over financial reporting in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of internal control.
  - — the auditor is not expressing an opinion on the effectiveness of internal control.
  - — the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified.
- an appropriate alert, in accordance with AU-C section 905.

.82 In explaining the potential effects of the significant deficiencies and material weaknesses, the auditor need not quantify those effects. The potential effects may be described in terms of the control objectives and types of errors the control was designed to prevent, or detect and correct, or in terms of the risk(s) of misstatement that the control was designed to address. The potential effects may be evident from the description of the significant deficiencies or material weaknesses.

.83 The significant deficiencies or material weaknesses may be grouped together for reporting purposes when it is appropriate to do so. The auditor also may include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement about whether the auditor has undertaken any steps to verify whether management's responses have been implemented (see paragraph .A33 of AU-C section 265 [discussed in paragraph .87 of this section]).

.84 The auditor may consider it appropriate to include the following information as additional context for the communication:

- The general inherent limitations of internal control, including the possibility of management override of controls
- The specific nature and extent of the auditor's consideration of internal control during the audit

.85 *Restriction on use.* In certain cases not involving *Government Auditing Standards*, law or regulation may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies and material weaknesses to governmental authorities. When this is the case, the auditor's written communication may identify such governmental authorities in the paragraph containing the alert that restricts the use of the auditor's written communication. AU-C section 905 does not permit the auditor to add parties, other than those identified in paragraph .07*b* of AU-C section 905.

.86 *Management's written response.* Management may wish to or may be required by a regulator to prepare a written response to the auditor's communication regarding significant deficiencies or material weaknesses identified during the audit. Such management communications may include a description of corrective actions taken by the entity, the entity's plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so. If such a written response is included in a document containing the auditor's written communication to management and those charged with governance concerning identified significant deficiencies or material weaknesses, the auditor may add a paragraph to the written communication disclaiming an opinion on such information. The following is an example of such a paragraph:

> ABC Company's written response to the significant deficiencies [*and material weaknesses*] identified in our audit was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

.87 *No material weakness communications.* When the auditor issues a written communication stating that no material weaknesses were identified during the audit, the communication should include the matters in paragraph .14*a* and *c–d* of AU-C section 265 (discussed in the paragraph .73 of this section).

.88 The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

.89 Management or those charged with governance may request a written communication indicating that no material weaknesses were identified during the audit. A written communication indicating that no material weaknesses were identified during the audit does not provide any assurance about the effectiveness of an entity's internal control over financial reporting. However, an auditor is not precluded from issuing such a communication, provided that the communication includes the matters required by paragraph .15 of AU-C section 265 (discussed in paragraph .87 of this section). However, a written communication indicating that no significant deficiencies were identified during the audit is precluded because such a communication has the potential to be misunderstood or misused.

Examples of Circumstances That May Be Deficiencies, Significant Deficiencies, or Material Weaknesses

.90 The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses.

Deficiencies in the Design of Controls

The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses related to the design of controls:

- Inadequate design of controls over the preparation of the financial statements being audited.
- Inadequate design of controls over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization (for example, the tone at the top and the control environment).
- Evidence of ineffective aspects of the control environment, such as indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk).
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of IT general and application controls that prevents the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles (GAAP), the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording the entity's financial transactions or preparing its financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.
- Absence of an internal process to report deficiencies in internal control to management on a timely basis.
- Absence of a risk assessment process within the entity when such a process would ordinarily be expected to have been established.

Failures in the Operation of Controls

The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses related to the operation of controls:

- Failure in the operation of effectively designed controls over a significant account or process (for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process).

- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements).
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs timely periodic physical inventory counts (detective control) with regard to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of *material weakness* and *significant deficiency* relate to the likelihood of misstatement of the financial statements, the failure of a preventive control, such as inventory tags, will not result in a significant deficiency or material weakness if the detective control (physical inventory counts) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent, or detect and correct, a material misstatement of the financial statements.
- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions (for example, consistent understatement of expenses or overstatement of allowances at the direction of management).
- Misrepresentation by entity personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
- An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

Illustrative Letters Communicating Internal Control Related Matters Identified in an Audit

.91 Written Communication Regarding Significant Deficiencies and Material Weaknesses Identified During an Audit of Financial Statements

> ***Note:*** When the engagement is also performed in accordance with *Government Auditing Standards*, the alert required by paragraph .14*d* of AU-C section 265 may read as follows: "The purpose of this communication is solely to describe the scope of our testing of internal control over financial reporting and the results of that testing. This communication is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Company's internal control over financial reporting. Accordingly, this communication is not suitable for any other purpose." The AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits* provides additional interpretative guidance, including illustrative reports.

[*Date of Auditor's Report on the Financial Statements*]

To Management and [*identify the body or individuals charged with governance, such as the entity's Board of Directors*] of ABC Company

In planning and performing our audit of the financial statements of [*client's name*] (the Company) as of and for the year ended [*financial statement date*], in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be [*material weaknesses or material weaknesses or significant deficiencies*] and therefore, [*material weaknesses or material weaknesses or significant deficiencies*] may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be [*material weaknesses or material weaknesses and significant deficiencies*].

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. We consider the following deficiencies in the Company's internal control to be material weaknesses:

Blank Checks

Blank checks are maintained in an unlocked cabinet along with the check signing machine.

Blank checks and the check signing machine should be locked in separate locations so as to prevent the embezzlement of funds.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in the Company's internal control to be significant deficiencies:

Accrued Vacation

Although accrued vacation has not been recorded on the financial statements, the amount of accrued vacation must be considered in determining the fair presentation of the financial statements. The year-end analysis of accrued vacation had a balance significantly lower than the prior year's balance. The details of the analysis were traced to the attendance control cards. We found (1) the number of days earned on the listing did not agree to that recorded in the cards, (2) individuals were reported in the cards with earned vacation but were not on the listing, and (3) some of the cards appeared to not have been maintained.

Detailed records of vacation days earned and used by employees should be recorded in a timely manner and accurately maintained. At least annually, these days should be converted to dollar amounts. Management should review the conversion and consider reporting this liability on the financial statements for complete recognition of liabilities.

Discussions with the office manager revealed that not all employees are required to notify him or her when they use vacation days. All employees should be required to inform the office manager of all vacation days taken. Employees should also be asked to periodically review their vacation records with the office manager and to indicate their agreement by signing the records.

Bad Debts

During 20XX, the board approved the write-off of accounts receivable of about $ [*amount*] The write-off was charged to revenue rather than to bad debt expense.

Procedures for recording bad debt write-offs should be reviewed for adequacy. All adjusting entries should be reviewed by the treasurer or a member of management other than the person preparing the journal entry.

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance, for example, the board of directors*], and others within the organization, and is not intended to be, and should not be, used by anyone other than these specified parties.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date*]

.92 Communicating Internal Control Related Matters Identified in an Audit When the Auditor Has Not Identified Any Material Weaknesses and Wishes to Communicate That to Management and Those Charged With Governance >

> ***Note:*** When the engagement is also performed in accordance with *Government Auditing Standards*, the alert required by paragraph .14*d* of AU-C section 265 may read as follows: "The purpose of this communication is solely to describe the scope of our testing of internal control over financial reporting and the results of that testing. This communication is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Company's internal control over financial reporting. Accordingly, this communication is not suitable for any other purpose." The AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits* provides additional interpretative guidance, including illustrative reports.

To Management and [*identify the body or individuals charged with governance, such as the entity's Board of Directors*] of NPO Organization

In planning and performing our audit of the financial statements of NPO Organization (the Organization) as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Organization's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Organization's internal control. Accordingly, we do not express an opinion on the effectiveness of the Organization's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

[*If one or more significant deficiencies have been identified, the auditor may add the following: Our audit was also not designed to identify deficiencies in internal control that might be significant deficiencies. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We communicated the significant deficiencies identified during our audit in a separate communication dated [date].*]

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any governmental authorities to which the auditor is required to report*] and is not intended to be, and should not be, used by anyone other than these specified parties.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date*]

The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

[*The next page is 7601.*]

AAM Section 7600

Reliance Letter

General

.01 CPA firms may receive a request from a third-party seeking reliance on a client's audited financial statements. The firm may respond with a reliance letter. These letters generally include a description of the services performed, the auditor's responsibilities, and an explanation of the inherent limitations of the audit process.

.02 Illustrative Reliance Letter

[*Addressee*]:

The following is in response to your letter to our firm dated ________.

We performed an audit of the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flow for the year then ended, and the related notes to the financial statements. The financial statements were audited as of the financial statement date and the audit procedures performed were completed on March 28, 20X2 [*date of the auditor's report*]. No additional audit procedures were performed subsequent to March 28, 20X2.

The audit was conducted in accordance with generally accepted auditing standards (GAAS). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. However, a properly designed and executed audit may not detect a material misstatement. For example, GAAS does not require that an auditor authenticate documents, nor is an auditor trained to do so. Also, audit procedures that are effective for detecting a misstatement that is unintentional may not be effective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

We understand that you intend to rely on the report and associated statements in connection with [*describe as precisely as possible the transaction in connection with which the third party intends to rely on the report and statements*]. It should be noted that the audit procedures performed in order to render an opinion on the financial statements of ABC Company may not be adequate or appropriate for this purpose. Because of the limitations inherent in the audit process, we may not have detected all material misstatements. Accordingly, our audit was not intended for your benefit and should not be taken to supplant the inquiries and procedures that you should take to satisfy yourself as to ABC Company's credit-worthiness. We recommend that you perform your own due diligence investing, which should include but not be limited to the following steps [*itemize*]. We emphasize that this list of procedures may not be all inclusive and that we cannot provide any assurance that the procedures we have mentioned will be sufficient for your purposes.

[*Signature*]

[*Date*]

[*The next page is 7701.*]

AAM Section 7700

Proposal Letter

General

.01 When a prospective client is considering engaging a CPA firm to provide services, the prospective client typically presents the firm with a request for proposal letter. In response to this request the CPA firm will provide a proposal letter to the prospective client. This letter will generally include the firm's background, objectives, experience, services, and an estimation of fees to perform the services requested.

.02 Illustrative Proposal Letter

[*Date*]

[*Name*]

[*Address*]

Dear [*Name*]:

We appreciate this opportunity to present a proposal for [*nature of services*] and a brief description of our firm and services.

Our firm was formed in 20X1. We have [*number of*] partners and [*number of*] staff and support personnel working with clients in accounting and auditing, taxation, and various consulting services. Although we serve all size clients, our clientele consists primarily of small and medium size businesses such as yours.

Our professional objectives are to provide the highest quality services on a timely basis. As a member of the AICPA Division for Firm's Private Companies Practice Section, our accounting and auditing practice has been subjected to a review by another firm of CPAs. We received an unqualified opinion as a result of that review. We extend our client relationships to include ongoing contact and services to achieve our services objectives.

We have extensive experience in the [*type of*] industry. This experience and related understanding of your industry's operations permit us to design, perform, and complete engagements for your company effectively and at a reasonable cost.

Our services include the following:

- Accounting, Auditing, and Attestation Services
  Our accounting, auditing, and attestation services include annual or special audits, compilations and reviews of financial statements, and the examination and review of financial and other information under the attestation standards. We accompany our report on audited financial statements with a letter communicating deficiencies in internal control and a management letter communicating recommendations for operational efficiencies. Our purpose in making these suggestions is to help you accomplish your operational objectives. These suggestions often result in cost savings.
- Tax Services
  We offer diversified tax services, including assistance in all phases of federal, state, and local income taxes; estate, inheritance, and gift taxes; and payroll and other taxes. These services include tax return preparation, tax research, and representation of clients at administrative proceedings before the various taxing authorities. The objectives of our tax services are to minimize taxes and potential problems.

- Consulting Services
  Our consulting services are designed to assist clients in improving efficiency and profitability. Our approach offers assistance in such areas as developing plans for problem identification or implementing more effective operating controls, evaluating information systems and installing or upgrading data processing systems.

[*Name*], an audit partner, will be primarily responsible for your engagement.

As you requested, our proposal is for [*state nature of services*].

We estimate that our fees for the proposed services will be approximately $[*amount*], plus out-of-pocket expenses, billable as the work progresses. Our fees are based on time spent on the engagement. Should we encounter any unforeseen circumstances requiring additional time, you will be notified promptly of the situation.

Our fee estimate is based on the assumption that your personnel will prepare certain schedules and analyses for us. We also anticipate their assistance in locating invoices and other documents for our examination.

Our firm is organized and staffed to help you satisfy our business needs. Please call [*number*] with questions about this proposal.

Sincerely,

____

[*Firm Signature*]

[*The next page is 8001.*]

AAM Section 8000
Alerts

The material included in this section is intended to provide CPAs with an overview of recent economic, industry, regulatory, and professional developments that may affect audits and other engagements they perform. The material in this section has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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AAM Section 8012

General Accounting and Auditing Developments—2013/14

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert (alert) replaces *General Accounting and Auditing Developments—2012/13*.

This alert is intended to provide auditors of financial statements with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards.

In applying the auditing guidance included in an other auditing publication, the auditor should, using professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

The AICPA gratefully acknowledges those members of the Auditing Standards Board and the AICPA Technical Issues Committee, who helped identify the interest areas for inclusion in this alert.

AICPA Staff

Liese Faircloth
Technical Manager
Accounting and Auditing Publications

The Audit Risk Alert *General Accounting and Auditing Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's alert, please feel free to share them with us. Any other comments you have about the alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits and also can be used by an entity's internal management to identify issues significant to the industry. It also provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about current accounting, auditing, and regulatory developments. For developing issues that may have a significant impact in the near future, the "On the Horizon" section provides information on these topics, including guidance that either has been issued but is not yet effective or is in a development stage.

.02 You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert.

.03 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. Auditors obtain audit evidence to draw reasonable conclusions on which to base their opinion by performing the following:

- Risk assessment procedures
- Further audit procedures that comprise
  - — tests of controls, when required by generally accepted auditing standards (GAAS) or when the auditor has chosen to do so
  - — substantive procedures that include tests of details and substantive analytical procedures

.04 The auditor should develop an audit plan that includes, among other things, the nature and extent of planned risk assessment procedures, as determined under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). AU-C section 315 defines *risk assessment procedures* as the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels. As part of obtaining the required understanding of the entity and its environment, paragraph .12 of AU-C section 315 states that the auditor should obtain an understanding of the industry, regulatory, and other external factors, including the applicable financial reporting framework, relevant to the entity. This alert assists the auditor with this aspect of the risk assessment procedures and further expands the auditor's understanding of other important considerations relevant to the audit.

Economic Developments

The Current Economy

.05 When planning an audit, auditors need to understand the economic conditions facing the industry in which an entity operates, as well as the effects of these conditions on the entity itself. These external factors, such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions, are likely to have an effect on an entity's business and, therefore, its financial statements. Considering the effects of external forces on an entity is part of obtaining an understanding of the entity and its environment. Recognizing that economic conditions and other external factors relevant to an entity and its environment constantly change, auditors should evaluate whether changes have occurred since the previous audit that may affect their reliance on any information obtained from their previous experience with the entity. These changes may affect the risks and risk assessment procedures applicable to the current year's audit.

.06 During 2012 and into 2013, the U.S. economy continued to recover. The S&P 500 and the Down Jones Industrial Average both reached all-time highs during 2013. The Chicago Board Options Exchange Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock option prices and is considered by many to indicate investor sentiment, market volatility, and the best gauge of fear in the market. The VIX continued to show a steady decline during the end of 2012 and into 2013. During that time, prices have ranged from 22.72–11.56. The volatility shows there is still some uncertainty; however, the continued downward trend shows that investors believe the economy and market are improving.

Key Economic Indicators

.07 The following key economic indicators reaffirm the recovery of the economy during 2013: gross domestic product (GDP), unemployment, and the federal fund rate. The GDP measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.4 percent in the first quarter of 2013, based on the advance estimate (second estimate). Real GDP increased at an annual rate of 0.4 percent in the fourth quarter of 2012. The increase in real GDP in the first quarter of 2013 has been attributed to positive contributions from personal consumption expenditures and residential fixed investments, among other factors.

.08 From May 2012 to May 2013, the unemployment rate fluctuated between 8.3 percent and 7.6 percent. A rate of 7.6 percent represents approximately 11.8 million people who are unemployed. Based on the Bureau of Labor Statistics (BLS), from May 2012 to May 2013, the average employment growth was 169,000 per month, which is an increase over 2011. During that same time period, the number of long-term unemployed (those jobless for 27 weeks or more) has decreased by 687,000, indicating more growth in the economy. Based on the BLS, the number of people employed part-time for economic reasons decreased to 7.6 million during the first quarter of 2013, down from 8 million at the end of 2012, and the average workweek for all private employees had increased 0.1 hour through the first quarter of 2013. Together, these statistics illustrate the overall improvement in the economy.

.09 The Board of Governors of the Federal Reserve System (Federal Reserve) decreased the target for the federal funds rate more than 5.0 percentage points, from its high of 5.25 percent prior to the financial crisis, to less than 0.25 percent, where it remains through May 2013. The Federal Reserve indicates that the target range for federal funds rates of 0 to 0.25 percent is appropriate for as long as the unemployment rate stays above 6.5 percent, inflation over the next two years is projected to be less than 0.5 percent above the 2-percent longer-run goal, and longer-term inflation projections continue to be low.

Sequestration

.10 In the past several years, Congress and the President have worked together to lower the deficit. In 2011, Congress passed a law that required a $4 trillion reduction in the deficit, including the $2.5 trillion that had already been accomplished. The new requirement was not met and, as a result, there was an automatic and arbitrary across-the-board cut in government spending. The sequestration went into effect in March of 2013. The cuts will be spread over 9 years but will amount to approximately $85 million in 2013. About 50 percent of the cuts will affect defense and national security. The other 50 percent will affect health care, education, law enforcement, disaster relief, unemployment benefits, nonprofit organizations, and scientific research. Many Americans believe these cuts will have a negative impact on the recovering economy.

Legislative and Regulatory Developments

American Taxpayer Relief Act of 2012

.11 On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (the act) after reaching an agreement to avoid the "fiscal cliff."

.12 With some modifications that increase taxes on the wealthiest Americans, the act permanently extends provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. It also permanently patches the alternative minimum tax and indexes it to inflation.

.13 The act's nontax features include one-year extensions of emergency unemployment insurance and agricultural programs and yet another postponement of automatic cuts in Medicare payments to physicians. In addition, it delayed until March 2013 a broad range of automatic federal spending cuts known as *sequestration* that otherwise would have begun in January 2013.

.14 The act temporarily extends many other tax provisions that had lapsed at midnight on December 31, 2012, and others that had expired a year earlier, reinstating them retroactively. Some of the provisions of the law that may be of interest include the following:

- Taxpayers age 70½ or older can donate up to $100,000 from Roth or traditional IRAs to certain charitable organizations without including the amount of their IRA withdrawals in gross income.
- The above-the-line deduction for qualified higher education tuition-related expenses for taxpayers with adjusted gross income below certain limits was extended.
- The deduction limitation for qualified conservation contributions is increased from 30 percent to 50 percent of the donor's contribution base over the amount of other charitable contributions.
- The deduction for contributions of apparently wholesome food from any trade or business is not limited to the taxpayer's basis in the food. The deduction is limited to 10 percent of the taxpayer's aggregate net income.

.15 Among the tax items not addressed by the act was the temporarily lower 4.2 percent rate for employees' portions of the Social Security payroll tax, which was not extended and has reverted to 6.2 percent.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.16 The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was signed into law in July 2010 in response to weaknesses in the financial services industry that are believed to have contributed to the economic recession. The main goals of the reform are to lower the systemic risks to the financial system and enhance consumer protections.

.17 The Dodd-Frank Act implements changes that affect the oversight and supervision of financial institutions and creates many new agencies. One of the main changes brought about by the Dodd-Frank Act was the creation of the Financial Stability Oversight Council (FSOC) that oversees financial institutions. The role of the FSOC, which is chaired by the Secretary of the Treasury, is to identify risks to financial stability and promote market discipline.

.18 Implementation of the Dodd-Frank Act is far behind schedule. Of the almost 400 rules that the act requires be finalized, only 153 are final as of May 2013. Another 117 have been proposed but have not been finalized by the regulators. One hundred twenty-eight rules have not been proposed.

Update on Derivatives Regulation

.19 Prior to the Dodd-Frank Act, no comprehensive framework for regulating swap agreements existed. The Dodd-Frank Act addresses the gap in the regulation of over-the-counter swaps by requiring that a number of rules are made in this area. The act splits the responsibilities for swaps between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). The SEC has regulatory authority over security-based swaps, which fall under the definition of security under the Securities Exchange Act of 1934 (the 1934 Act) and the Securities Act of 1933. The CFTC has primary regulatory authority over all other swaps, such as energy and agricultural swaps. The CFTC and SEC share authority over *mixed swaps*, which are security-based swaps that also have a commodity component. In addition, the SEC has antifraud enforcement authority over swaps that are related to securities but that do not come within the definition of security-based swap (referred to as *security-based swap agreements*). To assist the SEC in this responsibility, the act provides the SEC with access to information relating to security-based swap agreements in the possession of the CFTC and certain CFTC-regulated entities, such as derivatives clearing organizations, designated contract markets, and swap data repositories.

.20 The creation of rules required under the Dodd-Frank Act related to swaps is extensive and involves both the SEC and CFTC. Recent rules have been finalized regarding key terms—such as *swap*, *security-based swap*, and *security-based swap agreement*—along with *swap* and *security-based swap dealer*, *major swap*, and *security-based swap participants*. For up-to-date information on rule making, visit the SEC and CFTC websites at www.sec.gov and www.cftc.gov, respectively.

Audit and Attestation Issues and Developments

The Public Company Accounting Oversight Board

.21 In December 2012, the Public Company Accounting Oversight Board (PCAOB) released Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional Skepticism in Audits* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.10), which can be found at http://pcaobus.org/Standards/QandA/12-04-2012_SAPA_10.pdf. Auditing standards require that professional skepticism be applied throughout the audit by each individual auditor on the engagement team. Certain circumstances can impede the appropriate application of professional skepticism and allow unconscious biases to prevail, including incentives and pressures resulting from certain conditions inherent in the audit environment, scheduling and workload demands, or an inappropriate level of confidence or trust in management. Audit firms and individual auditors should be alert for these impediments and take appropriate measures to assure that professional skepticism is applied appropriately throughout all audits.

.22 It is the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including when identifying and assessing the risks of material misstatement, performing tests of controls and substantive procedures to respond to the risks, and evaluating the results of the audit. This involves, among other things, considering what can go wrong with the financial statements, performing audit procedures to obtain sufficient appropriate audit evidence, rather than merely obtaining the most readily available evidence to corroborate management's assertions, and critically evaluating all audit evidence, regardless of whether it corroborates or contradicts management's assertions.

.23 Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards.

The Auditing Standards Board's Clarity Project

.24 The goal of the Clarity Project was to make GAAS easier to read, understand, and apply. As the Auditing Standards Board (ASB) redrafted the standards for clarity, it also converged the standards with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB).

.25 As a result of the Auditing Clarity Project, a new section identifier, "AU-C," was established for the clarified auditing standards in order to avoid confusion with references to the "AU" sections in AICPA *Professional Standards*. The AU-C identifier had been scheduled to revert back to the AU identifier at the end of 2013, by which time the previous AU sections would be superseded for all engagements. However, in response to user requests, the AU-C identifier will be retained indefinitely. The superseded AU sections are still scheduled to be removed from AICPA *Professional Standards* at the end of 2013.

.26 At this point, auditors should be well on their way to transitioning to the clarified standards that became effective for audits of financial statements for periods ended on or after December 15, 2012. The new requirements may involve planning discussions with clients, affect interim testing and other fieldwork, and require changes to the auditor's report.

.27 Although the Clarity Project was not intended to create additional requirements, some revisions have resulted in substantive changes and primarily clarifying changes that may require auditors to make adjustments in their practices.

.28 In July 2013, the ASB amended AU-C section 920, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*). When AU section 634, *Letters for Underwriters and Certain Other Requesting Parties*, was redrafted and issued as AU-C section 920, the ASB did not intend to change or expand AU section 634 in any significant respect. The ASB believed that the substance of the last sentence in paragraph .42 of AU section 634, "In the case of a business combination, the historical financial statements of each constituent part of the combined entity on which the pro forma financial information is based should be audited or reviewed," had been appropriately captured in paragraph .53 of AU-C section 920. However, in order to reinforce the ASB's intention not to change practice and avoid unintended consequences, the ASB has added the following sentence as the penultimate sentence in paragraph .53 of AU-C section 920: "In the case of a business combination, the historical financial statements of each constituent part of the combined entity on which the pro forma financial information is based should be audited or reviewed."

.29 In January 2013, the AICPA issued Statement on Auditing Standards (SAS) No. 127, *Omnibus Statement on Auditing Standards—2013* (AICPA, *Professional Standards*). SAS No. 127 includes changes to AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, and AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*).

.30 AU-C section 600 was amended in several areas. Most importantly, the preconditions to making reference to others' work relating to the basis of a component's financial statement preparation when the financial reporting framework differs from the parent and the auditing standards followed by the component auditor, if the component auditor did not follow GAAS, were updated.

.31 The group engagement team may now make reference to the component audit that uses a different financial reporting framework, as long as the financial reporting framework is similar, and the group auditor has obtained sufficient appropriate audit evidence for the purpose of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group without the need to assume responsibility for, and, thus, be involved in, the work of the component auditor. In making reference to the component auditor, the group auditor should disclose the financial reporting framework used by the component and disclose that the auditor of the group financial statements is taking responsibility for evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group. New application material that addresses making reference when the financial reporting frameworks differ has also been added.

.32 Making reference to the component auditor when the component auditor is not in accordance with GAAS is precluded unless the component auditor has performed an audit that meets the relevant requirements of GAAS. Paragraph .A54 of AU-C section 600 provides guidance on how the group engagement partner may determine that the audit performed by the component auditor meets the relevant requirements of GAAS. The additional guidance provided by SAS No. 127 includes relevant requirements pertaining to planning and performing the component audit. The component auditor may perform additional procedures to meet the relevant requirements of GAAS. If the relevant requirements are met, the group audit report should disclose the set of auditing standards used by the component auditor and that additional procedures were performed by the component auditor to meet the relevant requirements of GAAS.

.33 An additional amendment to AU-C section 600 is added clarification that the group audit engagement team is required to determine the component materiality for those components for which the group engagements team will assume responsibility for the work of a component auditor who performs an audit or review.

.34 AU-C section 800 was amended by SAS No. 127 to add "Other Basis" to the list of special purpose frameworks. The *other basis* is defined as a basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

.35 With the issuance of SAS No. 127, the ASB has redrafted all but one of the auditing sections, which now reflect the ASB's established clarity drafting conventions.

.36 For information on the final clarified auditing standard, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, to be released as part of the Clarity Project, see the "On the Horizon" section of this alert.

Substantive Changes

.37 The following AU-C sections in AICPA *Professional Standards* are considered likely to affect the firms' audit methodology and engagements because they contain *substantive or other changes*, defined as having one or both of the following characteristics: (*a*) a change or changes to an audit methodology that may require effort to implement or (*b*) a number of small changes that, although not individually significant, may affect audit engagements:

- AU-C section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
- AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*
- AU-C section 550, *Related Parties*
- AU-C section 600
- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*

Primarily Clarifying Changes

.38 The following AU-C sections have clarifying changes that are intended to explicitly state what may have been implicit in the previous standards that, over time, resulted in diversity in practice. Certain clarified standards address management responsibilities that may need to be communicated to clients early in the planning stage. Some of these requirements may already be performed in practice, although not explicitly required by the previous standards. Most notably, certain new requirements shift the timing of requirements from the reporting stage of an audit to the planning stage. The new requirements in this section may not have a substantial effect but may result in adjustments to the timing and responsibilities of the auditor and his or her clients and will need to be reviewed by the auditor to ensure that all requirements have been properly addressed. These AICPA standards include the following:

- AU-C section 210, *Terms of Engagement*
- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
- AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*
- AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items*
- AU-C section 505, *External Confirmations*
- AU-C section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*
- AU-C section 620, *Using the Work of an Auditor's Specialist*
- AU-C section 708, *Consistency of Financial Statements*
- AU-C section 800
- AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*
- AU-C section 810, *Engagements to Report on Summary Financial Statements*

- AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication*
- AU-C section 910, *Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country*

Resources for the Clarity Standards

.39 A wealth of information about the clarity standards is available at www.aicpa.org/SASClarity. Also, two publications specifically discuss the clarity standards:

- The AICPA Audit Risk Alert *Understanding the Clarified Auditing Standards—2012* (product nos. ARACLA12P, ARACLA12E, or ARACLA12O) identifies the substantive and clarifying changes in requirements from the Clarity Project and includes a mapping schedule tracking the pre-clarity standards to the clarified standards.
- Additionally, the AICPA Audit Risk Alert *Understanding the Responsibilities of Auditors for Audits of Group Financial Statements—2013* (product nos. ARAGRP13P, ARAGRP13E, or ARAGRPO) provides additional guidance for implementing AU-C section 600.

.40 These publications are available at www.cpa2biz.com. Additionally, see the section "Resource Central" for ways to obtain the codified clarity standards.

Financial Reporting Framework for Small- and Medium-Sized Entities

.41 The Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs™) accounting framework has been developed by the AICPA FRF for SMEs Task Force (task force) and staff of the AICPA as a special purpose framework for small- and medium-sized entities. It is a self-contained financial reporting framework that may be appropriate for entities that do not need to prepare financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP).

.42 The FRF for SMEs accounting framework draws upon a blend of traditional accounting principles and accrual income tax methods of accounting. It utilizes historical cost as its primary measurement basis. In addition, it provides management with a suitable degree of optionality when choosing accounting policies to better meet the needs of the end users of the financial statements. The framework avoids prescriptive, detailed standards and voluminous disclosure requirements. Being a more intuitive and understandable framework for small business owners and the users of their financial statements, the framework lays out principles that encourage the use of professional judgment in the particular circumstances of a transaction or event.

.43 The AICPA believes that the framework is criteria suitable for general use financial statements and can be used by users external to the entity. An important pillar of the framework is that its use requires the exercise of professional judgment. The key attributes of the framework are as follows:

- *Objectivity*. The framework is free from bias.
- *Measurability*. The framework permits reasonably consistent measurements.
- *Completeness*. The framework is sufficiently complete so that those relevant factors that would alter a conclusion about the financial statements are not omitted.
- *Relevance.* The framework is relevant to financial statement users.

Scope and Characteristics of Entities Utilizing the FRF for SMEs Accounting Framework

.44 The FRF for SMEs accounting framework has been developed for small- to medium-sized entities that require reliable non-GAAP financial statements for internal use and external uses. The task force believes that this framework can be used by entities in many industry groups and may also be used by unincorporated, as well as incorporated, entities. The framework is not intended to be a substitute for GAAP when GAAP-based financial statements are necessary, as determined by the management of a private company and its financial statement users.

.45 A standard definition of small- and medium-sized entities does not exist in the United States. However, the term is intuitive, widely recognized, and effectively descriptive of the scope of entities for which the FRF for SMEs accounting framework is intended. Size criteria for determining what a small- or medium-sized entity is were deliberately not developed to quantify size. Rather, characteristics of typical entities that may utilize the framework are presented. Ultimately, the decision regarding which accounting framework best meets an entity's financial reporting needs rests with management.

Certain Characteristics of Small- and Medium-Sized Entities Utilizing the FRF for SMEs Accounting Framework

.46 This list presents certain characteristics of typical entities that may utilize the FRF for SMEs accounting framework. These characteristics are not all-inclusive and are not presented as a list of required characteristics an entity must possess in order to utilize it:

- The entity does not have regulatory reporting requirements that essentially require it to use GAAP-based financial statements.
- A majority of the owners and management of the entity have no intention of going public.
- The entity is for-profit.
- The entity may be owner-managed, which is a closely held company in which the people who own a controlling ownership interest in the entity are substantially the same set of people who run the company.
- Management and owners of the entity rely on a set of financial statements to confirm their assessments of performance, cash flows, and of what they own and what they owe.
- The entity does not operate in an industry in which the entity is involved in transactions that require highly-specialized accounting guidance, such as financial institutions and governmental entities.
- The entity does not engage in overly complicated transactions.
- The entity does not have significant foreign operations.
- Key users of the entity's financial statements have direct access to the entity's management.
- Users of the entity's financial statements may have greater interest in cash flows, liquidity, statement of financial position strength, and interest coverage.
- The entity's financial statements support applications for bank financing when the banker does not base a lending decision solely on the financial statements but also on available collateral or other evaluation mechanisms not directly related to the financial statements.

Application of FRF for SMEs Accounting Framework Principles, Concepts, and Criteria

.47 The FRF for SMEs accounting framework was developed to address transactions that are typically encountered by private, for-profit, small-, and medium-sized entities. If the framework does not specifically address a transaction, other event, or condition, management should use its judgment and apply the general principles, concepts, and criteria contained in the framework when developing accounting policies. The development and application of those policies should result in financial information that is intended to be consistent with the financial statement concepts of the FRF for SMEs accounting framework.

Authority and Effective Date of the FRF for SMEs Accounting Framework

.48 The AICPA has no authority to require the use of the FRF for SMEs accounting framework for any entity. Therefore, use of the framework is purely optional. Management that prepares an entity's financial statements in accordance with the framework may represent or assert that such financial statements have been prepared in accordance with the AICPA's FRF for SMEs accounting framework, a special purpose framework.

.49 Because use of the framework is optional, there is no effective date for its implementation.

Maintenance of the FRF for SMEs Accounting Framework

.50 Appreciating the limited accounting resources that typical entities utilizing the FRF for SMEs accounting framework have, as well as the nature of their financial reporting, the framework is intended to be a stable platform that does not undergo frequent amending or updating. At the same time, it is intended to be responsive to the financial reporting needs of small- and medium-sized entities and, therefore, will be modified in response to significant developments in accounting and financial reporting matters affecting those entities.

.51 Accordingly, the task force and AICPA staff intend to monitor and assess input related to the implementation of the framework after its initial release and propose modifications as necessary. Afterwards, staff, with assistance from the task force, intends to review and propose amendments to the framework approximately every three or four years. Amendments will be primarily based on input from stakeholders and developments in accounting and financial reporting.

.52 The AICPA's Accounting and Auditing Technical Hotline provides members with free, high-quality technical assistance by phone concerning issues related to accounting and financial reporting, auditing and attestation, compilation, and review standards. Technical questions about the FRF for SMEs accounting framework can be directed to the technical hotline.

Group Audits

.53 *Group audits* involve the audit of financial statements that include the financial information of more than one component (group financial statements). AU-C section 600 expands previous guidance related to using the work of other auditors to encompass audits of group financial statements. AU-C section 600 introduces a number of new terms, concepts, and requirements related to group audits that will significantly affect current practice. Because AU-C section 600 is much broader than previous guidance, it is important for auditors to fully understand the requirements therein. AU-C section 600 is effective for audits of group financial statements for periods ending on or after December 15, 2012.

.54 The following questions and answers point out some of the major changes in the new standard, which may assist auditors in recognizing when they are involved in an audit of group financial statements:

- *What are group financial statements?* Group financial statements include the financial information of more than one component. The concept of group financial statements is broader than consolidated or combined financial statements because it encompasses business activities in addition to separate entities. Additionally, this standard applies in all audits of group financial statements, regardless of whether different auditors are involved in the audit.
- *What is a component?* A *component* is an entity or business activity for which group or component management prepares financial information that is required to be included in the group financial statements. A component may include, but is not limited to, subsidiaries, geographical locations, divisions, investments, products or services, functions, processes, or component units of state or local governments. Equity method investments are also components that are scoped into the standard. However, other investments using fair value measurements are generally not considered components.
- *How are the previous concepts of*other auditor *and* principal auditor *changed in this standard?* The focus of the previous standard was the interaction between the auditors. AU-C section 600 changes that focus to the unique characteristics of a group reporting entity and how an auditor should obtain sufficient audit evidence to render an opinion on the group financial statements. An auditor who performs work on the financial statements, or financial information, of a component is now referred to as the *component auditor*, rather than an *other auditor*. The *auditor of the group financial statements*, which encompasses the firm and group engagement team, including the group engagement partner, replaces the concept of the *principal auditor*. A member of the group engagement team may perform

work on the financial information of a component for the group audit at the request of the group engagement team. When this is the case, such a member of the group engagement team is also a component auditor. Note that when the component is being audited by the group engagement team, the group engagement team is filling the role of the component auditor. Although members of the group engagement team may be filling the role of a component auditor, typically, this will not add any additional performance requirements to the group audit other than, in some circumstances, the need to apply component materiality.

- *Do the requirements change for making reference to the work of other auditors?* AU-C section 600 better articulates the degree of involvement required when reference is made to the audit of component auditors in the auditor's report on the group financial statements. It establishes certain conditions that are necessary for the group engagement partner to make reference to a component auditor in the auditor's report on the group financial statements. Moreover, AU-C section 600 clarifies that the group engagement partner is responsible for the opinion on the group financial statements, regardless of whether reference is made to component auditors. Additionally, AU-C section 600 establishes requirements that apply to all group audits, regardless of whether reference is made to the work of the component auditor. These requirements expand the level of communication with the component auditors and the considerations of the group engagement partner when determining the acceptability of using the component auditor's work.
- *Are there new procedures that are required when assuming responsibility for the work of other auditors?* Certain provisions of AU-C section 600 apply to all group audits, regardless of whether reference is made to the audit of a component auditor in the auditor's report on the group financial statements. AU-C section 600 specifically articulates the procedures the group engagement team is required to perform when a component auditor is involved in the group audit. Additional specific procedures are applicable when the auditor of the group financial statements assumes responsibility for the work of a component auditor or is performing audit procedures on the components directly.

.55 The Alert *Understanding the Responsibilities of Auditors for Audits of Group Financial Statements—2013* summarizes the new standard and provides implementation guidance for the auditor of the group financial statements. For component auditors, it also describes the specific matters that the group engagement team is required to communicate to the component auditor and requests that the component auditor also communicate with the group engagement team. However, auditors will need to read AU-C section 600, including its application material, in its entirety to fully understand its effect on current practice.

The Auditor's Report

.56 Requirements related to the form and content of auditor's reports are contained in AU-C section 700. This section is the basis of the reporting standards. It maintains the auditors' responsibilities for reporting on financial statements as required by the standards in all significant respects. However, the form of the auditor's report differs from the pre-clarity standards in that it

- requires the use of headings to highlight
  - management's responsibility for the financial statements,
  - the auditor's responsibility, and
  - the auditor's opinion.
- describes management's and the auditor's responsibilities in greater detail.
- requires the city and state where the auditor practices to be stated.

.57 The clarified auditing standards related to auditor's reports continue to build upon the base established in AU-C section 700. AU-C section 705 contains guidance related to modifications to the opinion in the independent auditor's report.

.58 AU-C section 706 introduces two new terms, *emphasis-of-matter* and *other-matter paragraphs*, replacing the term *explanatory paragraph*:

- An *emphasis-of-matter paragraph* is any paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements. Some emphasis-of-matter paragraphs are required by certain standards, whereas others are added at the discretion of the auditor, consistent with current practice. However, all such paragraphs are to be considered emphasis-of-matter paragraphs because they are intended to draw the users' attention to a particular matter that is appropriately presented or disclosed in the financial statements.
- An *other-matter paragraph* is a paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to the users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

.59 Accordingly, the term *explanatory paragraph* is no longer a recognized element of the auditor's report in GAAS. Instead, additional communications in the auditor's report are labeled as either emphasis-of-matter or other-matter paragraphs. AU-C section 706 requires an emphasis-of-matter or other-matter paragraph to always follow the opinion paragraph and to be included in a separate section of the auditor's report under the heading "Emphasis of Matter" or "Other Matter" or other appropriate heading.

.60 The clarified standards (AICPA, *Professional Standards*) continue to build upon the base reporting requirements established in AU-C section 700 in the following:

- AU-C section 708
- AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*
- AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole*
- AU-C section 730, *Required Supplementary Information*

.61 These sections address consistency of financial statements, as well as other information in documents containing audited financial statements. Reporting on supplementary information and required supplementary information is also addressed within these sections.

.62 An auditor reporting on financial statements prepared in accordance with special purpose frameworks will follow the requirements and guidance in AU-C section 800. The previous sections still apply, but this section addresses special considerations in the application of those AU-C sections to an audit of financial statements prepared in accordance with a special purpose framework, which is a cash, tax, regulatory, or contractual basis of accounting.

.63 An auditor is sometimes engaged to report on a single financial statement or on a specific element, account, or item of a financial statement. Requirements and guidance related to this reporting is contained in AU-C section 805. Again, AU-C sections 200–700 apply, and this section addresses special considerations in the application of those AU-C sections to these circumstances. In addition, if the financial statements are prepared in accordance with a special purpose framework, AU-C section 800 also applies to the audit.

.64 When a firm discovers that it issued an audit report in accordance with AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), on financial statements for a period ended after December 15, 2012, the firm should consider AU-C section 585, *Consideration of Omitted Procedures After the Report Release Date* (AICPA, *Professional Standards*). After considering AU-C section 585, the firm should apply its professional judgment to determine whether it should recall its "outdated" report and reissue a new report in accordance with AU-C section 700. When a firm decides to reissue its audit report, the auditor should also get an updated representation letter with the new report date. More information and examples can be found in the AICPA online tool *The Auditor's Report: Comprehensive Guidance and Examples* (product no. APAARMO).

Common Peer Review Findings

.65 In order to be admitted to or retain their membership in the AICPA, members who are engaged in the practice of public accounting in the United States or its territories are required to be practicing as partners or employees of firms enrolled in an approved practice-monitoring program or, if practicing in firms not eligible to enroll, are themselves enrolled in such a program if the services performed by such a firm or individual are within the scope of the AICPA's practice-monitoring standards, and the firm or individual issues reports purporting to be in accordance with AICPA professional standards.

.66 Firms have peer reviews because of the public interest in the quality of the accounting, auditing, and attestation services provided by public accounting firms. In addition, firms indicate that peer review contributes to the quality and effectiveness of their practices. Furthermore, most state boards of accountancy require their licensees to undergo peer review, which they may also call *compliance assurance*, to practice in their state. Other regulators require peer review in order to perform engagements and issue reports under their standards.

.67 Firms are encouraged to remain current with changes in the standards because the standards are the basis for peer reviews. Training and frequently asked questions about the AICPA Peer Review program can be found at www.aicpa.org/InterestAreas/PeerReview/Pages/PeerReviewHome.aspx.

.68 The most common findings in recent peer reviews are as follows:

- Lack of disclosure of the date through which subsequent events have been evaluated
- Lack of disclosure of open tax years
- Lack of documentation of expectations for analytical procedures
- Lack of documentation around risk assessment procedures
- Engagement letters not updated for current engagement

Updated COSO Framework

.69 In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published an update to the 1992 *Internal Control—Integrated Framework* (the framework). The updates became necessary due to the increasing complexity of businesses since the original framework was published. The changes are intended to make the framework easier for management to use while, at the same time, allow management to meet the entity's financial and operations goals.

.70 Internal control is not one event or circumstance, but a dynamic, iterative, and integrated process. It is not a one-time task because the impact of an entity's internal and external activities is not static but is continually changing. The entity's policies reflect management or board statements of what should be done to effect internal control. These statements may be explicitly stated in management communication or implied through management actions and decisions.

.71 The updated framework recognizes that technology is used much more in business than it was in 1992, when the original framework was published. The updated framework also provides examples of how to apply the principles of the framework for public, private, and not-for-profit entities.

.72 The updated framework retains the 5 components of internal control used in the original and incorporates 17 principles representing the fundamental concepts associated with the components. A summary of the components and listing of the principles associated with the components follows:

- **Control Environment.** The set of standards, processes, and structures that provide the basis for carrying out internal control across the entity. The board of directors and senior management establish the tone at the top regarding the importance of internal control and expected standards of conduct.

- Commitment to integrity and ethical values
- Board oversight and independence
- Appropriate authority, responsibilities, and reporting
- Commitment to competence
- Accountability

- **Risk Assessment.** A dynamic and iterative process for identifying and analyzing risks to achieving the entity's objectives, forming a basis for determining how risks should be managed. Management considers possible changes in the external environment and within its own business model that may impede its ability to achieve its objectives.
  - Objective setting
  - Identification of risks
  - Consideration of fraud
  - Identification and assessment of risk for changes
- **Control Activities.** The actions established by policies and procedures to help ensure that management directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity and at various stages within business processes and over the technology environment.
  - Appropriate control policies
  - General technology controls
  - Selection and development of appropriate control activities
- **Information and Communication.** Information is necessary for the entity to carry out internal control responsibilities in support of achieving its objectives. Communication occurs both internally and externally and provides the organization with the information needed to carry out day-to-day internal control activities. Communication enables personnel to understand internal control responsibilities and their importance to the achievement of objectives.
  - Obtains and uses quality and reliable information to perform control activities
  - Communication of objective and responsibilities
  - Communication with third parties
- **Monitoring Activities.** Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control, including controls to effect the principle within each component, is present and functioning. Findings are evaluated, and deficiencies are communicated in a timely manner, with serious matters reported to senior management and the board of directors.
  - Evaluation of controls and control activities to determine presence and functionality
  - Evaluation of strength of controls, along with reporting and response by organization

.73 The original framework will be available until December 15, 2014, but COSO is encouraging entities to adopt the new framework prior to that date.

Accounting Issues and Developments

.74 Because the financial reporting standards are in a constant state of change, it may be challenging to keep up with all the new standards as they are issued. Auditors and preparers need to be aware of the following Financial Accounting Standards Board (FASB) Accounting Standards Updates (ASUs) that have been recently issued and become effective in the near term.

Business Combinations

.75 In October 2012, FASB issued ASU No. 2012-06, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution (a consensus of the FASB Emerging Issues Task Force)*. This ASU affects all entities that recognize an indemnification asset in accordance with FASB *Accounting Standards Codification* (ASC) 805-20 as a result of a government-assisted acquisition of a financial institution.

.76 When a reporting entity recognizes an indemnification asset as a result of a government-assisted acquisition of a financial institution and, subsequently, a change in the cash flows expected to be collected on the indemnification asset occurs (as a result of a change in cash flows expected to be collected on the assets subject to indemnification), the reporting entity should subsequently account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification. Any amortization of changes in value should be limited to the contractual term of the indemnification agreement (that is, the lesser of the term of the indemnification agreement and the remaining life of the indemnified assets).

.77 This ASU is effective for public and nonpublic entities, and the amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. Early adoption is permitted. The amendments should be applied prospectively to any new indemnification assets acquired after the date of adoption and to indemnification assets existing as of the date of adoption arising from a government-assisted acquisition of a financial institution.

Offsetting Assets and Liabilities in the Balance Sheet

.78 In January 2013, FASB issued ASU No. 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. This ASU affects entities that have derivatives accounted for in accordance with FASB ASC 815, *Derivatives and Hedging*, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and lending transactions that are either offset in accordance with FASB ASC 210-20-45 or FASB ASC 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. Entities with other types of financial assets and financial liabilities subject to a master netting arrangement or similar agreement also are affected because these amendments make them no longer subject to the disclosure requirements in ASU No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*.

.79 The amendment clarifies that the scope of ASU No. 2011-11 applies to derivatives accounted for in accordance with FASB ASC 815, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and lending transactions that are either offset in accordance with FASB ASC 210-20-45 or FASB ASC 815-10-45 or subject to an enforceable master netting arrangement or similar agreement.

.80 This ASU is currently effective for public entities. It is effective for nonpublic entities for impairment assessments performed on or after December 15, 2013. The amendments resulting from this ASU should be applied prospectively.

Comprehensive Income

.81 In February 2013, FASB issued ASU No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. This ASU applies to all entities that issue financial statements that are presented in conformity with U.S. GAAP and that report items of other comprehensive income. Public companies are required to comply with these amendments for all reporting periods presented, including interim periods. Nonpublic entities are required to comply with all the requirements of the amendments for annual reporting periods. For interim reporting periods, nonpublic entities are not required to report the effects of reclassifications on net income but are required to report information about the amounts reclassified out of accumulated other comprehensive income by component for each reporting period. Not-for-profit entities that report under the requirements of FASB ASC 958-205 are excluded from the scope of these amendments.

.82 Under the amendments to FASB ASC 220, *Comprehensive Income*, entities are required to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts.

.83 This ASU is effective for public entities for reporting periods beginning after December 15, 2012. For nonpublic entities, the amendments to FASB ASC 220 are effective prospectively for reporting periods beginning after December 15, 2013. Early adoption is permitted.

Financial Instruments

.84 In February 2013, FASB issued ASU No. 2013-03, *Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities*. This ASU affects nonpublic entities that have total assets of $100 million or more or have one or more derivative instruments.

.85 The amendments to FASB ASC 825, *Financial Instruments*, clarify that the requirement to disclose "the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)" does not apply to nonpublic entities for items that are not measured at fair value in the statement of financial position but for which fair value is disclosed.

.86 This ASU became effective upon issuance on February 7, 2013.

Obligations Resulting From Joint and Several Liability

.87 In February 2013, FASB issued ASU No. 2013-04, *Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date (a consensus of the FASB Emerging Issues Task Force)*. This ASU applies to all entities, both public and nonpublic, that have obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this guidance is fixed at the reporting date and for which no specific guidance exists.

.88 The guidance in this ASU requires an entity to measure obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this guidance is fixed at the reporting date as the sum of the following:

- The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors
- Any additional amount the reporting entity expects to pay on behalf of its co-obligors

.89 The guidance in this ASU also requires an entity to disclose the nature and amount of the obligation, as well as other information about those obligations.

.90 The amendments to FASB ASC 405, *Liabilities*, in this ASU are effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2013. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2014, and interim periods and annual periods thereafter.

.91 The amendments to FASB ASC 405 in this ASU should be applied retrospectively to all prior periods presented for those obligations resulting from joint and several liability arrangements within FASB ASC's scope that exist at the beginning of an entity's fiscal year of adoption. An entity may elect to use hindsight for the comparative periods (if it changed its accounting as a result of adopting the amendments in this ASU) and should disclose that fact. Early adoption is permitted.

Foreign Currency

.92 In March 2013, FASB issued ASU No. 2013-05, *Foreign Currency Matters (Topic 830): Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity (a consensus of the FASB Emerging Issues Task Force)*. This ASU affects entities that cease to hold a controlling financial interest (as described in FASB ASC 810-10) in a subsidiary or group of assets within a foreign entity when (*a*) the subsidiary or group of assets is a nonprofit activity or business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights), and (*b*) there is a cumulative translation adjustment balance associated with that foreign entity. The amendments also affect entities that lose a controlling financial interest in an investment in a foreign entity (by sale or other transfer event) and those that acquire a business in stages (sometimes also referred to as a step acquisition) by increasing an investment in a foreign entity from one accounted for under the equity method to one accounted for as a consolidated investment.

.93 When a reporting entity (parent) ceases to have a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights) within a foreign entity, the parent is required to apply the guidance in FASB ASC 830-30 to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided.

.94 For an equity method investment that is a foreign entity, the partial sale guidance in FASB ASC 830-30-40 still applies. As such, a pro rata portion of the cumulative translation adjustment should be released into net income upon a partial sale of such an equity method investment. However, this treatment does not apply to an equity method investment that is not a foreign entity. In those instances, the cumulative translation adjustment is released into net income only if the partial sale represents a complete or substantially complete liquidation of the foreign entity that contains the equity method investment.

.95 Additionally, the amendments in this ASU clarify that the sale of an investment in a foreign entity includes both (*a*) events that result in the loss of a controlling financial interest in a foreign entity (that is, irrespective of any retained investment) and (*b*) events that result in an acquirer obtaining control of an acquiree in which it held an equity interest immediately before the acquisition date (sometimes also referred to as a *step acquisition*). Accordingly, the cumulative translation adjustment should be released into net income upon the occurrence of those events.

.96 The amendments to FASB ASC 830, *Foreign Currency Matters*, are effective prospectively for public companies for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. For nonpublic entities, the amendments in this ASU are effective prospectively for the first annual period beginning after December 15, 2014, and interim and annual periods thereafter. The amendments should be applied prospectively to derecognition events occurring after the effective date. Prior periods should not be adjusted. Early adoption is permitted. If an entity elects to adopt the amendments early, it should apply them as of the beginning of the entity's fiscal year of adoption.

Liquidation Basis of Accounting

.97 In April 2013, FASB issued ASU No. 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*. The amendments apply to all entities that issue financial statements that are presented in conformity with U.S. GAAP, except investment companies that are regulated under the Investment Company Act of 1940.

.98 This ASU requires an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. Liquidation is imminent when the likelihood is remote that the entity will return from liquidation and either (*a*) a plan for liquidation is approved by the person or persons with the authority to make such a plan effective, and the likelihood is remote that the execution of the plan will be blocked by other parties, or (*b*) a plan for liquidation is being imposed by other forces (for example, involuntary bankruptcy). If a plan for liquidation was specified in the entity's governing documents from the entity's inception (for example, limited-life entities), the entity should apply the liquidation basis of accounting only if the approved plan for liquidation differs from the plan for liquidation that was specified at the entity's inception.

.99 The amendments to FASB ASC 205, *Presentation of Financial Statements*, require financial statements prepared using the liquidation basis of accounting to present relevant information about an entity's expected resources in liquidation by measuring and presenting assets at the amount of the expected cash proceeds from liquidation. The entity should include in its presentation of assets any items it had not previously recognized under U.S. GAAP but that it expects to either sell in liquidation or use in settling liabilities (for example, trademarks).

.100 An entity should recognize and measure its liabilities in accordance with U.S. GAAP that otherwise applies to those liabilities. The entity should not anticipate that it will be legally released from being the primary obligor under those liabilities, either judicially or by creditor(s). The entity also is required to accrue and separately present the costs that it expects to incur and the income that it expects to earn during the expected duration of the liquidation, including any costs associated with sale or settlement of those assets and liabilities.

.101 Additionally, the amendments to FASB ASC 205 require disclosures about an entity's plan for liquidation, the methods and significant assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of the liquidation process.

Fair Value

.102 In July 2013, FASB issued ASU No. 2013-09, *Fair Value Measurement (Topic 820): Deferral of the Effective Date of Certain Disclosures for Nonpublic Employee Benefit Plans in Update No. 2011-04*. The amendments in this ASU defer indefinitely the effective date of certain required disclosures in ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, of quantitative information about the significant unobservable inputs used in level 3 fair value measurements for investments held by a nonpublic employee benefit plan in its plan sponsor's own nonpublic entity equity securities, including equity securities of its plan sponsor's nonpublic affiliated entities. These changes do not defer the effective date for those certain quantitative disclosures for other nonpublic entity equity securities held in the nonpublic employee benefit plan or any qualitative disclosures.

Derivatives and Hedging

.103 In July 2013, FASB issued ASU No. 2013-10, *Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes (a consensus of the FASB Emerging Issues Task Force)*. FASB ASC 815 provides guidance on the risks that are permitted to be hedged in a fair value or cash flow hedge. Among those risks for financial assets and financial liabilities is the risk of changes in a hedged item's fair value or a hedged transaction's cash flows attributable to changes in the designated benchmark interest rate (referred to as interest rate risk). In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government (UST) and, for practical reasons, the London Interbank Offered Rate (LIBOR) swap rate are considered benchmark interest rates.

.104 As a result of the financial crisis in 2008, the exposure to, and the demand for, hedging the Fed Funds rate have increased significantly. That demand has been driven by an increased focus by banks on their sources of funding (including an increased focus on overnight interbank borrowings of surplus balances held at the Federal Reserve) the greater (and sometimes volatile) spread between LIBOR and Federal Funds Effective

Swap Rate or Overnight Index Swap Rate (OIS), and new regulatory measures to curb systemic risks (such as increased collateralization of derivatives). Considering the increased importance of OIS, the objective of this ASU is to provide for the inclusion of the OIS as a U.S. benchmark interest rate for hedge accounting purposes, in addition to UST and LIBOR.

.105 The ASU permits the OIS to be used as a U.S. benchmark interest rate for hedge accounting purposes under FASB ASC 815, in addition to UST and LIBOR. The amendments also remove the restriction on using different benchmark rates for similar hedges.

.106 The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013.

Income Taxes

.107 In July 2013, FASB issued ASU No. 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force)*. FASB ASC 740, *Income Taxes*, does not include explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. There is diversity in practice in the presentation of unrecognized tax benefits in those instances. Some entities present unrecognized tax benefits as a liability unless the unrecognized tax benefit is directly associated with a tax position taken in a tax year that results in, or that resulted in, the recognition of a net operating loss or tax credit carryforward for that year, and the net operating loss or tax credit carryforward has not been utilized. Other entities present unrecognized tax benefits as a reduction of a deferred tax asset for a net operating loss or tax credit carryforward in certain circumstances. The objective of the amendments in this ASU is to eliminate that diversity in practice.

.108 This ASU applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date.

.109 An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position, or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. For example, an entity should not evaluate whether the deferred tax asset expires before the statute of limitations on the tax position or whether the deferred tax asset may be used prior to the unrecognized tax benefit being settled.

.110 The ASU does not require new recurring disclosures.

.111 The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. For nonpublic entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. Early adoption is permitted.

.112 The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted.

Recent Pronouncements

Recent Auditing and Attestation Pronouncements and Related Guidance

.113 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 127, *Omnibus Statement on Auditing Standards—2013* (AICPA, *Professional Standards*) Issue Date: January 2013	This SAS amends AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, and AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*). This statement includes amendments that address making reference to the audit of a component auditor when the component's financial statements are prepared using a different financial reporting framework, clarify and provide guidance when determining that a component auditor has performed an audit that meets the relevant requirements of generally accepted auditing standards, clarify requirements for determining component materiality, and expand the definition of special purpose framework of accounting. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2012.

Recent ASUs

.114 The following table presents, by codification area, a list of recently issued ASUs through the issuance of ASU No. 2013-11. However, this table does not include ASUs that are SEC updates or that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but content labeled as "SEC staff guidance" does not constitute rules or interpretations of the SEC, nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Presentation Area of Financial Accounting Standards Board (FASB) ***Accounting Standards Codification*** **(ASC)®**	
Accounting Standards Update (ASU) No. 2013-07 (April 2013)	*Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*
ASU No. 2013-02 (February 2013)	*Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*
ASU No. 2013-01 (January 2013)	*Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*
ASU No. 2012-05 (October 2012)	*Statement of Cash Flows (Topic 230): Not-for-Profit Entities: Classification of the Sale Proceeds of Donated Financial Assets in the Statement of Cash Flows (a consensus of the FASB Emerging Issues Task Force)*
Liabilities Area of FASB ASC	
ASU No. 2013-04 (February 2013)	*Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date (a consensus of the FASB Emerging Issues Task Force)*

Recent Accounting Standards Updates	
Broad Transactions Area of FASB ASC	
ASU No. 2013-11 (July 2013)	*Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2013-10 (July 2013)	*Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2013-09 (July 2013)	*Fair Value Measurement (Topic 820): Deferral of the Effective Date of Certain Disclosures for Nonpublic Employee Benefit Plans in Update No. 2011-04*
ASU No. 2013-05 (March 2013)	*Foreign Currency Matters (Topic 830): Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2013-03 (February 2013)	*Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities*
ASU No. 2012-06 (October 2012)	*Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution (a consensus of the FASB Emerging Issues Task Force)*
Industry Area of FASB ASC	
ASU No. 2013-08 (June 2013)	*Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*
ASU No. 2013-06 (April 2013)	*Not-for-Profit Entities (Topic 958): Services Received from Personnel of an Affiliate (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2012-07 (October 2012)	*Entertainment—Films (Topic 926): Accounting for Fair Value Information That Arises after the Measurement Date and Its Inclusion in the Impairment Analysis of Unamortized Film Costs (a consensus of the FASB Emerging Issues Task Force)*

Recently Issued Technical Questions and Answers

.115 The following table presents a list of recently issued nonauthoritative audit, attest, and accounting Technical Questions and Answers (AICPA, *Technical Practice Aids*) issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/FRC/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Recently Issued Technical Questions and Answers	
Group Audits	
Technical Questions and Answers (TIS) section 8800.43 (June 2013)	"Using Another Accounting Firm to Perform Inventory Observations"
TIS section 8800.42 (June 2013)	"Component Audit Report of Balance Sheet Only"
TIS section 8800.41 (March 2013)	"Component Using a Different Basis of Accounting Than the Group"

(continued)

Recently Issued Technical Questions and Answers	
Group Audits	
TIS section 8800.40 (March 2013)	"Variable Interest Entities (VIEs) as a Component"
TIS section 8800.39 (February 2013)	"Disaggregation of Account Balances or Classes of Transactions"
TIS section 8800.38 (February 2013)	"Using Net Asset Value to Calculate Fair Value"
TIS section 8800.37 (February 2013)	"Employee Benefit Plan Using Investee Results to Calculate Fair Value"
TIS section 8800.36 (February 2013)	"Investments Held in a Financial Institution Presented at Cost or Fair Value"
TIS section 8800.35 (February 2013)	"Component and Group Have Different Year-Ends"
TIS section 8800.34 (February 2013)	"Subsequent Events Procedures Relating to a Component"
TIS section 8800.33 (February 2013)	"Structure of Component Auditor Engagement"
TIS section 8800.32 (February 2013)	"Issuance of Component Auditor's Report"
TIS section 8800.31 (February 2013)	"Review of Component That Is Not Significant Performed by Another Practitioner"
TIS section 8800.30 (February 2013)	"Making Reference to Review Report"
TIS section 8800.29 (February 2013)	"Equity Investee's Financial Statements Reviewed, and Investment Is a Significant Component"
TIS section 8800.28 (February 2013)	"Lack of Response From a Component Auditor"
TIS section 8800.27 (February 2013)	"Circumstances in Which Making Reference Is Inappropriate"
TIS section 8800.26 (February 2013)	"Procedures Required When Making Reference to the Audit of an Equity Method Investee"
TIS section 8800.25 (February 2013)	"Applicability of AU-C Section 600 When Making Reference to the Audit of an Equity Method Investee"
TIS section 8800.24 (February 2013)	"Applicability of AU-C Section 600 When Only One Engagement Team Is Involved"
TIS section 8800.23 (February 2013)	"Use of Component Materiality When the Component Is Not Reported On Separately"
TIS section 8800.22 (November 2012)	"Form of Communications With Component Auditors"
TIS section 8800.21 (November 2012)	"Factors Affecting Involvement in the Work of a Component Auditor"
TIS section 8800.20 (November 2012)	"Involvement in the Work of a Component Auditor"
TIS section 8800.19 (November 2012)	"Understanding of Component Auditor Whose Work Will Not Be Used"

Recently Issued Technical Questions and Answers	
Group Audits	
TIS section 8800.18 (November 2012)	"Determining Component Materiality"
TIS section 8800.17 (November 2012)	"Inclusion of Component Auditor in Engagement Team Discussions"
TIS section 8800.16 (November 2012)	"Responsibilities With Respect to Fraud in a Group Audit"
TIS section 8800.15 (November 2012)	"Restricted Access to Component Auditor Documentation"
TIS section 8800.14 (November 2012)	"No Significant Components Are Identified"
TIS section 8800.13 (November 2012)	"Criteria for Identifying Significant Components"
TIS section 8800.12 (November 2012)	"Criteria for Identifying Components"
TIS section 8800.11 (November 2012)	"Equity Method Investment Component"
TIS section 8800.10 (November 2012)	"Terms of the Group Audit Engagement"
TIS section 8800.09 (November 2012)	"Component Audit Performed by Other Engagement Teams of the Same Firm"
TIS section 8800.08 (November 2012)	"Component Audit Performed in Accordance With *Government Auditing Standards*"
TIS section 8800.06 (November 2012)	"Governmental Financial Statements That Include a GAAP-Basis Component"
TIS section 8800.04 (November 2012)	"Factors to Consider Regarding Component Auditors"
TIS section 8800.03 (November 2012)	"Deciding to Act as Auditor of Group Financial Statements"
TIS section 8800.02 (November 2012)	"Making Reference to Any or All Component Auditors"
TIS section 8800.01 (November 2012)	"Applicability of AU-C Section 600"
Health Care Entities	
TIS section 6400.52 (October 2012)	"Insurance Recoveries From Certain Retrospectively Rated Insurance Policies"
TIS section 6400.51 (October 2012)	"Presentation of Insurance Recoveries When Insurer Pays Claims Directly"
TIS section 6400.50 (October 2012)	"Accrual of Legal Costs Associated With Contingencies Other Than Malpractice"
TIS section 6400.49 (October 2012)	"Presentation of Claims Liability and Insurance Recoveries—Contingencies Similar to Malpractice"
TIS section 6400.48 (October 2012)	"Accounting for Costs Incurred During Implementation of ICD-10"

(continued)

Recently Issued Technical Questions and Answers	
Insurance	
TIS section 6300.40 (October 2012)	"Deferrable Commissions and Bonuses Under ASU No. 2010-26"
TIS section 6300.39 (October 2012)	"Cumulative Effect of Change in Accounting Principle—ASU No. 2010-26"
Investment Companies	
TIS section 6910.35 (February 2013)	"Assessing Control When Measuring Fair Value"
TIS section 6910.34 (February 2013)	"Application of the Notion of Value Maximization for Measuring Fair Value of Debt and Controlling Equity Positions"
Reporting	
TIS section 9100.08 (June 2013)	"Audit Firm With Multiple Offices on Their Company Letterhead and Effect on Report"
TIS section 9100.07 (October 2012)	"Naming the City and State Where the Auditor Practices"
TIS section 9110.23 (March 2013)	"Modification of Compliance Report When Financial Statements Are Audited in Accordance With GAAS"
TIS section 9110.22 (March 2013)	"Use of Restricted Alert Language When Financial Statements Are Audited in Accordance With GAAS and *Government Auditing Standards*"
TIS section 9110.21 (March 2013)	"Reporting on Current-Value Financial Statements That Supplement Historical-Cost Financial Statements in Presentations of Real Estate Entities"
TIS section 9110.20 (December 2012)	"Effective Date of AU-C Section 905 in a Compliance Audit"
TIS section 9170.02 (October 2012)	"Supplementary Information That Accompanies Interim Financial Information"
Other Topics	
TIS section 9110.19 (July 2012)	"Lender Comfort Letters"

Recent AICPA Independence and Ethics Developments

.116 The Alert *Independence and Ethics Developments—2012/13* (product no. ARAIET12P) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at 888.777.7077 or visiting www.cpa2biz.com.

AICPA Code of Professional Conduct

.117 The AICPA's Professional Ethics Executive Committee (PEEC) is proposing to restructure and codify the AICPA Code of Professional Conduct (AICPA Code) so that members and other users of the AICPA Code can apply the rules and reach correct conclusions more easily and intuitively. To achieve this, PEEC is proposing to restructure the AICPA Code into several parts organized by topic, edit it using consistent drafting and style conventions, incorporate a conceptual framework for members in public practice and business, revise certain provisions to reflect the conceptual framework approach (also known as the *threats and safeguard approach*), and, where applicable, reference existing nonauthoritative guidance to the relevant topic. It is PEEC's intent to maintain the substance of the existing AICPA ethics standards. PEEC believes this was achieved; however, during the process, PEEC identified some areas that needed revision and have been highlighted as substantive changes.

New Structure of the Code

.118 The restructured AICPA Code is divided into separate parts. The first part is the preface, which is applicable to all members and covers topics such as the structure of the code; the principles of professional conduct; the defined terms that are used in the code; nonauthoritative guidance; and new, revised, and pending interpretations. The remaining three parts are divided according to a member's practice. Part 1 is applicable to members in public practice, part 2 is applicable to members in business, and part 3 is applicable to all other members, such as those who are retired or unemployed. By structuring the AICPA Code this way, PEEC believes that members will be able to easily identify what provisions apply to them. For members who are both in public practice and business, content that is relevant to both parts appears in the corresponding citation (an explanation of numeric citations follows). The actual content differs only where necessary (for example, part 1 might refer to a firm, whereas part 2 might refer to employer).

Numeric Citations

.119 The new citation numbering system for the AICPA Code looks like this: ET section X.XXX.XXX. The single digit that begins the citation identifies in which part the content resides. Accordingly, content from the preface begins with the single digit 0.XXX.XXX, whereas content for part 1 begins with a 1.XXX.XXX, part 2 with a 2.XXX.XXX, and part 3 with a 3.XXX.XXX. Next are two sets of three digit numbers that identify the topics and, when applicable, subtopics or sections. To facilitate use, when a topic, subtopic, or section appears in two or more parts, the same number is used.

Rules of Conduct

.120 The bylaws of the AICPA require that members adhere to the rules of the AICPA Code. This has not changed with the restructured code. However, the specific rule numbers are no longer being used. For example, Rule 101, *Independence*, is now referred to as the Independence Rule. In addition, the manner in which the interpretations are aligned with the rules has changed. In the currently effective version of the AICPA Code, content is aligned under the applicable rules, whereas in the restructured AICPA Code, the rules are aligned with the interpretations under a broad topic. For example, the Contingent Fees Rule and Commission and Referral Fees Rule and related interpretations appear under ET section 1.500, "Fees and Other Types of Remuneration."

.121 Given this construct, there are some situations in which the rule appears multiple times in the AICPA Code. For example, the Integrity and Objectivity Rule appears under the Integrity and Objectivity topic of both parts 1 and 2. However, the interpretations of this rule do not necessarily appear in both parts 1 and 2. Rather, they are aligned with the member's practice. For example, under the Integrity and Objectivity topic, there is a subtopic called Conflicts of Interest in both parts 1 and 2. In part 1, there is an interpretation that addresses conflicts of interest concerns when a member in public practice is also a director of an entity. However, this interpretation does not appear in part 2 because it would not be applicable to such members.

.122 Finally, all ethics rulings have been redrafted as interpretations and codified under the appropriate topic.

Conceptual Framework

.123 PEEC proposes to incorporate two conceptual framework interpretations into the restructured AICPA Code: one for members in public practice and another, very similar, one for members in business. In addition, for members in public practice who provide attest services to clients, there is a conceptual framework for independence that focuses on the specific threats to independence. The conceptual framework for independence is a redraft of the extant *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*, ET sec. 100-1). These conceptual framework interpretations are designed to assist members when they encounter a relationship or circumstance that creates threats to their compliance with the rules and when the AICPA Code contains no specific guidance to assist the member. When specific guidance is absent, under the conceptual framework interpretations, the member should evaluate whether that circumstance or relationship would lead a reasonable and informed third party that is aware of the relevant information to conclude that there is an unacceptable threat to the member's compliance with the rules.

.124 In addition to the two conceptual framework interpretations, certain interpretations were recast to reflect the conceptual framework approach that represents a significant change. For example, the existing interpretation that prohibits a covered member from having a direct financial interest in a client is proposed to read as follows:

> If a covered member had or was committed to acquire any direct financial interest in an attest client during the period of the professional engagement, the self-interest threat to the covered member's compliance with the Independence Rule would not be at an acceptable level and could not be reduced by the application of safeguards. Accordingly, independence would be impaired.

.125 PEEC believes this will enhance understanding of the AICPA Code by providing additional context to the code and guidance on the application of the framework. However, recasting will not change the substance of the existing AICPA Code by allowing members to apply judgment where none is permitted today. For example, as noted in the preceding statement, if a covered member holds stock in an audit client, the only safeguard that would eliminate or sufficiently mitigate the self-interest threat to independence would be to eliminate the interest or cease being a covered member, which is the same requirement as under the current AICPA Code. Thus, recasting does not weaken the code or allow for judgment where none is permitted now. Some interpretations in the code, such as those for acts discreditable, false advertising, and confidentiality, do not lend themselves to a conceptual framework approach and, as such, were not recast. For those interpretations, PEEC applied only drafting and style conventions.

Nonauthoritative Guidance

.126 The primary objectives of restructuring the AICPA Code is so that members and other users can apply the code more easily, thus, minimizing the risk of misapplication. To assist members in understanding and applying the AICPA Code, periodically, the Ethics division develops nonauthoritative guidance (for example, frequently asked questions and Basis for Conclusions documents) that resides outside the AICPA Code. As described in the "Nonauthoritative Guidance" section of the Ethics codification, during the restructuring, PEEC reevaluated the nonauthoritative guidance and either proposed that some of it be made authoritative and incorporated into the revised AICPA Code or aligned links to the nonauthoritative content with the relevant topic. The revised AICPA Code is expected to be issued in 2014.

Nonattest Services

.127 Several changes to Interpretation No. 101-3, "Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05), were made. PEEC believes these revisions will add clarity to the nonattest services guidance and enhance practitioners' understanding of the interpretation's requirements. Changes adopted affecting nonattest services included the following:

- Providing a limited exception to the period of impairment
- Clarifying language regarding the general requirements for performing nonattest services, including enhanced definitions of management responsibilities
- Defining activities related to attest services and, therefore, not constituting a nonattest service subject to Interpretation No. 101-3
- Technical corrections to compliance requirements with independence regulations of certain regulatory bodies
- Addition of nonattest services
- Independence monitoring activities

.128 More detailed information on each of the changes follows.

Period of Impairment Limited Exception When Performing Nonattest Services

.129 Interpretation No. 101-3 states that members performing attestation services must remain independent during the period covered by the financial statements and the period of the professional engagement. This interpretation was modified to provide a limited exception if prohibited services were performed during the period covered by the financial statements, provided that the nonattest services were provided prior to the period of the professional engagement; the nonattest services related only to periods prior to the period covered by the financial statements; and the financial statements for the period to which the nonattest services relate were audited by another firm (or, in the case of a review engagement, reviewed by another firm).

Management's Responsibilities When Performing Nonattest Services

.130 The term *management responsibilities* replaces the term *management functions*. PEEC believes that the term *management responsibilities* will better help members distinguish between management responsibilities and other types of services. In addition, this change converges terms used by other standard-setting bodies. A member assuming management responsibilities for an attest client would create a management participation threat so significant that no safeguards could reduce the threat to an acceptable level and, therefore, would impair independence. The interpretation adds explanatory language on what constitutes *management responsibilities*, which are defined as involving leading and directing an entity, including making significant decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources.

.131 Examples of activities that would be considered a management responsibility and would impair independence if performed for an attest client include

- setting policies or strategic direction for the client.
- directing or accepting responsibility for the actions of the client's employees, except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards.
- authorizing, executing, or consummating a transaction or otherwise exercising authority on behalf of a client or having the authority to do so.
- preparing source documents, in electronic or other form, evidencing the occurrence of a transaction.
- having custody of client assets.
- deciding which recommendations of the member or other third parties to implement or prioritize.
- reporting to those in charge of governance on behalf of management.
- serving as a client's stock transfer or escrow agent, registrar, general counsel, or its equivalent.
- accepting responsibility for the management of a client's project.
- accepting responsibility for the preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework.
- accepting responsibility for designing, implementing, or maintaining internal controls.
- performing ongoing evaluations of the client's internal control as part of its monitoring activities.

.132 Additional examples of nonattest services when independence would not be impaired were added for performance of reconciliations and network maintenance services.

.133 Members are cautioned that regulatory bodies, such as the SEC and Government Accountability Office, may have different requirements and, therefore, should be consulted when performing attestation work under those standards.

Activities Not Considered Nonattest Service Because the Activities Are Considered to Be Related to Attest Services

.134 PEEC also clarified that when performing attest services, members often have communications with the client that are a routine part of the engagement and, therefore, are not considered nonattest services and subject to the general requirements of Interpretation No. 101-3. Such communications may include the following:

- Client's selection and application of accounting standards or policies and financial statement disclosure requirements
- Appropriateness of a client's methods used in determining the accounting and financial reporting
- Adjusting journal entries that the member prepared or proposed for the client's consideration
- The form or content of the financial statements

Engagements Subject to Independence Rules of Certain Regulatory Bodies

.135 Changes to Interpretation No. 101-3 added the PCAOB as an example authoritative regulatory body for which compliance is required when performing nonattest services for a client for which independence is required under regulations of the regulatory body.

Additional Nonattest Services

.136 This revision concludes that financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of the attest engagement and, therefore, constitute nonattest services subject to the general requirements of the interpretation. This revision is effective for engagements covering periods beginning on or after December 15, 2014.

Independence Monitoring Activities

.137 This revision clarifies the impact that performing ongoing and separate evaluations have on independence. Although the revisions include a description of these two types of monitoring activities, members seeking further guidance on distinguishing between ongoing and separate evaluations are directed to the COSO *Internal Control—Integrated Framework*. This revision is effective for engagements covering periods beginning on or after December 15, 2013.

On the Horizon

.138 Auditors should keep abreast of accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.139 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard-setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

Auditing and Attestation Pipeline—Nonissuers

ASB Issues Exposure Draft to Amend AU Section 322

.140 The ASB has completed the clarity redrafting of its last AU section in AICPA *Professional Standards* and has issued the proposed SAS *Using the Work of Internal Auditors*. This proposed SAS would supersede AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*), and AU-C section 610A, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*), and, among other amendments, would also significantly amend AU-C section 315. The proposed SAS is converged with ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, to reflect developments in the internal auditing environment and changes in practice regarding the interactions between the external and internal auditors.

.141 Consistent with ISA 610 (Revised 2013), the proposed SAS introduces the concept of a systematic and disciplined approach, which is not included in pre-clarity AU-C section 610A. Paragraph 14 of the proposed SAS would require, among other things, as a prerequisite to being able to use the work of the internal audit function, that the external auditor evaluate the application by the internal audit function of a systematic and disciplined approach, including quality control. Paragraphs A10–A12 of the proposed SAS provide application guidance regarding the application of a systematic and disciplined approach. The ASB believes that relative to our pre-clarity standards, this requirement represents an additional and explicit evaluation that the external auditor would need to perform to conclude on the appropriateness of using the work of internal auditors.

Attestation Standards Clarity Project

.142 The Attestation Recodification Task Force is in the process of clarifying Statements on Standards for Attestation Engagements (SSAEs) and converging them with the International Standards on Assurance Engagements issued by the IAASB. The task force has developed a draft SSAE that would replace the more general attestation standards (AT sections 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*; 50, *SSAE Hierarchy*; 101, *Attest Engagements*; and 201, *Agreed-Upon Procedures Engagements* [AICPA, Professional Standards]). Once this material is finalized, the task force expects to focus on the subject matter-specific standards (that is, AT sections 301–801).

.143 The following are some of the conclusions reached by the ASB regarding the proposed clarified attestation standards:

- The practitioner should be required to obtain a written assertion in an examination or review engagement.
- If the responsible party refuses to provide written representations, and the responsible party is not the engaging party, the practitioner may report directly on the subject matter and restrict the use of the report to the engaging party.
- The clarified attestation standards should include a preface that explains what the attestation standards are and how they are organized.
- A risk assessment model should be incorporated in the section of the attestation standards that addresses examination engagements.
- The guidance in the clarified attestation standards should not be overburdened by the incorporation of all the detailed requirements in the clarified auditing standards.
- The illustrative examination reports should address a variety of subject matters, for example, qualitative subject matter, such as the effectiveness of controls.
- The guidance on compilations of prospective financial statements will be removed from the attestation standards, and the AICPA Accounting and Review Services Committee will address this topic.

.144 The ASB discussed a revised draft of the proposed general attestation standards at its May 2013 meeting.

Auditing and Attestation Pipeline—Issuers

Auditor's Reporting Model

.145 In August 2013, the PCAOB proposed a new auditing standard to enhance the auditor's reporting model. The proposed standard would retain the pass/fail model and the basic elements of the current auditor's report, but would require the auditor to communicate a wider range of information specific to the particular audit.

.146 The proposed standard would require

- the communication of critical audit matters as determined by the auditor;
- enhancements to existing language in the auditor's report related to the auditor's responsibilities for fraud and notes to the financial statements; and
- the addition of new elements to the auditor's report related to
  - auditor independence;
  - auditor tenure; and
  - the auditor's responsibilities for, and the results of, the auditor's evaluation of other information outside the financial statements.

Critical Audit Matters

.147 *Critical audit matters* are those matters the auditor addressed during the audit of the financial statements that

- involved the most difficult, subjective, or complex auditor judgments;
- posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; and
- posed the most difficulty to the auditor in forming an opinion on the financial statements.

.148 Critical audit matters ordinarily are matters of such importance that they are

- included in engagement completion documents;
- reviewed by the engagement quality reviewer; and
- communicated to the audit committee.

.149 Factors that the auditor should take into account when determining critical audit matters are as follows:

- The degree of subjectivity involved when determining or applying audit procedures to address the matter or when evaluating the results of those procedures.
- The nature and extent of audit effort required to address the matter.
- The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence.
- The severity of control deficiencies identified relevant to the matter, if any.
- The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any.
- The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any.

- The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
- The nature of consultations outside the engagement team regarding the matter, if any.

.150 The description for each critical audit matter in the auditor's report would

- identify the critical audit matter;
- describe the considerations that led the auditor to determine that the matter is a critical audit matter; and
- refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

Proposed Other Information Standard

.151 Under existing PCAOB standards, the auditor has a responsibility to "read and consider" other information with no related reporting requirements.

.152 The proposed standard would

- apply the auditor's responsibility for other information specifically to a company's annual report filed with the SEC under the 1934 Act that contains the company's audited financial statements and the related auditor's report.
- enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform when evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit.
- require the auditor to evaluate the other information for a material misstatement of fact, as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements.
- require communication in the auditor's report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

Related Parties

.153 The PCAOB is reproposing the following:

- An auditing standard, *Related Parties*
- Amendments to certain PCAOB auditing standards regarding significant unusual transactions
- Other amendments to PCAOB auditing standards

.154 The proposed auditing standard would supersede the PCAOB's AU section 334, *Related Parties* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).

.155 Related party transactions have been contributing factors in numerous prominent financial reporting frauds over the last few decades. Financial reporting frauds also have involved significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature (significant unusual transactions) and a company's financial relationships and transactions with its executive officers. Corporate scandals involving these areas, such as financial reporting frauds at Enron Corporation; Tyco International, Ltd.; Refco, Inc.; and WorldCom, Inc. undermined investor confidence and resulted in significant losses for investors, as well as the loss of many jobs for employees. These critical areas have continued to be a contributing factor in more recent cases. The reproposed standard and amendments would update and strengthen auditor performance requirements in these critical areas, which could pose significant risks of material misstatement in company financial statements. The critical areas addressed by the reproposed standard and amendments include

- relationships and transactions with related parties;
- significant unusual transactions; and
- financial relationships and transactions with executive officers.

.156 The PCAOB is proposing changes in these three critical areas contemporaneously because it believes that the auditor's efforts in these areas complement each other. For example, focusing the auditor's identification and evaluation of significant unusual transactions might assist the auditor in identifying related parties or relationships or transactions with related parties that management has not previously disclosed to the auditor. Similarly, performing procedures to obtain an understanding of a company's financial relationships and transactions with its executive officers might provide the auditor with information that indicates the existence of related party relationships or transactions previously undisclosed to the auditor. Both the auditor and the investor benefit from a comprehensive and consistent examination of these areas, not only because of the risk of material misstatement due to fraud, but also because these transactions, due to their nature, pose a risk of material misstatement due to error.

.157 The reproposed standard and amendments would update the PCAOB's standards and focus the auditor's efforts on these critical areas that could pose significant risks of material misstatement to company financial statements. In the PCAOB's view, this update is particularly appropriate due to the number and magnitude of financial reporting frauds, and resulting investor losses, associated with these areas.

PCAOB Framework

.158 In March 2013, the PCAOB proposed a framework for reorganizing the existing interim and PCAOB-issued auditing standards into a topical structure with a single integrated numbering system. In addition, the PCAOB is proposing certain conforming amendments to Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, and Rule 3200T, *Interim Auditing Standards* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board). The PCAOB also is proposing certain related amendments to the its auditing standards and proposing to rescind certain interim auditing standards that it believes are no longer necessary under the proposed reorganization.

.159 In April 2003, the PCAOB issued Rule 3200T, which adopted, on an interim transitional basis, GAAS of the ASB of the AICPA that were in existence on April 16, 2003. For those "interim auditing standards," the PCAOB retained the organization and reference numbers (AU sections) used in the ASB's preexisting codification of its standards.

.160 Since the adoption of the interim auditing standards, the PCAOB has issued 16 new standards that, collectively, have superseded 10 interim standards and amended the majority of the remaining auditing standards to varying degrees. The standards issued by the PCAOB have been numbered sequentially based on the order in which they were issued.

.161 Consequently, the PCAOB's existing auditing standards consist of sequentially numbered standards issued by the PCAOB (the AS standards) and the AU sections representing the remaining interim standards that the PCAOB has not superseded.

.162 To enhance the usability of the PCAOB's auditing standards, the PCAOB is proposing to reorganize its existing auditing standards into a topical structure with a single, integrated numbering system. The proposed reorganization is intended to present the standards in a logical order that generally follows the flow of the audit process.

.163 The proposed reorganization also is intended to help users navigate the standards more easily, for example, to find the relevant standard for a particular area of the audit. It also would help avoid potential confusion between the PCAOB's standards and the recently reorganized standards of the ASB, if the same AU section reference is used for different standards covering different topics. In addition, the proposed reorganization framework is intended to provide a structure for updating PCAOB standards in the future.

.164 The proposed reorganization of PCAOB auditing standards would involve reordering and renumbering existing standards in their entirety without redrafting the auditing standards or making substantive changes to the requirements of the standards. Also, in conjunction with the proposed reorganization of PCAOB auditing standards, the PCAOB is proposing to rescind certain auditing standards that it believes are no longer necessary under the proposed reorganization. Implementation of the proposed reorganization of PCAOB auditing standards would require a number of amendments, for example, to update the reference numbers and cross-references to reflect the new section numbers and remove references to rescinded standards. The changes to the auditing standards resulting from the proposed reorganization are not expected to impose new requirements on auditors or substantively change the requirements of PCAOB standards.

.165 Under this proposal, all PCAOB auditing standards would be reorganized into a topical structure, with the topics grouped into the following categories:

- *General Auditing Standards*. Standards on broad auditing principles, concepts, activities, and communications.
- *Audit Procedures*. Standards for planning and performing audit procedures and obtaining audit evidence.
- *Auditor Reporting*. Standards for auditors' reports.
- *Matters Relating to Filings under Federal Securities Laws*. Standards on certain auditor responsibilities relating to SEC filings for securities offerings and reviews of interim financial information.
- *Other Matters Associated with Audits*. Standards for other work performed in conjunction with an audit of an issuer or a broker or dealer.

.166 Within each category are subcategories to further organize similar topics, such as standards related to auditor communications in the General Auditing Standards category.

.167 The integrated referencing system would use an "AS" prefix to identify the auditing standards, which is consistent with common practice for describing standards issued by the PCAOB (for example, "AS No. 7" for the standard on engagement quality review).

.168 Each standard would be assigned a unique section number, based on a four-digit numbering system. Using a four-digit system would facilitate the grouping of auditing standards into logical categories and subcategories by topic and would avoid potential confusion with the standards of the IAASB or ASB. If the proposed reorganization is adopted, future auditing standards would be issued as new or replacement sections and paragraphs within the new framework.

.169 Although the proposed framework for reorganization of PCAOB auditing standards would not mirror the organizational structure of the standards of the IAASB, the reorganized structure could facilitate comparison of PCAOB and IAASB standards. For example, both the IAASB standards and the proposed reorganization of PCAOB auditing standards begin with general standards, followed by standards for audit procedures and auditor reporting. Many of the differences between the proposed reorganization of PCAOB auditing standards and the organizational structure of the IAASB's standards generally relate to the content of the standards themselves, rather than the arrangement of the standards. For example, the topics in multiple PCAOB standards might be covered in one IAASB standard or vice versa.

Accounting Pipeline

Consolidation

.170 In August 2013, FASB issued proposed ASU *Consolidation (Topic 810): Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements (a proposal of the Private Company Council)*. The amendments in this proposed ASU would permit a private company to elect not to apply variable interest entity guidance for assessing whether it should consolidate a lessor entity when (*a*) the lessor entity and the private company are under common control, (*b*) the private company has a leasing arrangement with the lessor entity, and (*c*) substantially all the activity between the two entities is related to the leasing activity of the lessor entity.

.171 The accounting alternative, when elected, would be an accounting policy election that would be applied by a private company to all current and future lessor entities under common control that meet the criteria for applying this approach.

.172 If a private company lessee elects to apply the guidance in this proposed ASU, it would be required to disclose additional information about each applicable lessor entity. Such disclosures would include the key terms of the leasing arrangements, the amount of debt or significant liabilities, or both, of the lessor entity under common control, the key terms of existing debt agreements of the lessor entity under common control, and the key terms of any other explicit interest related to the lessor entity under common control. In addition, entities that elect this alternative should continue to apply other applicable FASB ASC guidance, including FASB ASC 840, *Leases*, and FASB ASC 460, *Guarantees*.

Troubled Debt Restructuring

.173 In July 2013, FASB issued proposed ASU *Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Collateralized Mortgage Loans upon a Troubled Debt Restructuring (a consensus of the FASB Emerging Issues Task Force)*. The amendments in this proposed ASU would clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon (*a*) the creditor obtaining legal title to the residential real estate property or (*b*) completion of a deed in lieu of foreclosure or similar legal agreement under which the borrower conveys all interest in the residential real estate property to the creditor to satisfy that loan, even though legal title may not yet have passed. In addition, the proposal would require that an entity that receives physical possession of residential real estate property collateralizing a consumer mortgage loan disclose a roll-forward schedule reconciling the change from the beginning to the ending balance of such foreclosed properties at every reporting period. An entity would also be required to disclose the recorded investment in consumer mortgage loans secured by residential real estate properties that are in the process of foreclosure according to local requirements of the applicable jurisdiction.

Service Concession Arrangements

.174 In July 2013, FASB issued proposed ASU *Service Concession Arrangements (Topic 853) (a consensus of the FASB Emerging Issues Task Force)*. The proposal would apply to an operating entity of a service concession arrangement entered into with a public sector entity grantor when the arrangement contains both of the following conditions:

- The grantor controls, or has the ability to modify or approve, the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price.
- The grantor controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement.

.175 The proposed amendments would specify that an operating entity should not account for a service concession arrangement within the scope of this proposed ASU as a lease in accordance with FASB ASC 840. An operating entity would refer to other relevant FASB ASC topics as applicable to account for various aspects of a service concession arrangement. The proposal also specifies that the infrastructure used in a service concession arrangement would not be recognized as property, plant, and equipment of the operating entity.

Consolidation

.176 In July 2013, FASB issued proposed ASU *Consolidation (Topic 810): Measuring the Financial Liabilities of a Consolidated Collateralized Financing Entity (a consensus of the FASB Emerging Issues Task Force)*. The amendments in this proposed ASU would apply to reporting entities that are required to consolidate a collateralized financing entity under the "Variable Interest Entity" subsections of FASB ASC 810-10. The proposal would define a *collateralized financing entity* as an entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. All the beneficial interests that have recourse to the related financial assets of the collateralized financing entity are classified as financial liabilities. Under the proposed amendments, a collateralized financing entity also may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity.

.177 The amendments would allow a reporting entity within the scope of this proposed ASU to measure the financial liabilities of the collateralized financing entity using the following calculation:

- The sum of the following two amounts: the fair value of the financial assets held by the collateralized financing entity and the carrying value of any nonfinancial assets held by the collateralized financing entity
- Less the sum of the following two amounts: the sum of the fair value of financial assets and the carrying value of nonfinancial assets attributable to the beneficial interest owned by the reporting entity and the carrying value of any beneficial interests that represent compensation for services rendered by the reporting entity

.178 A reporting entity would allocate the preceding calculated value to the individual financial liabilities on a reasonable and consistent basis using a methodology appropriate in the circumstances. Beneficial interests that represent compensation for services (such as management fees) and nonfinancial assets that are being held temporarily by a collateralized financing entity would be measured in accordance with other applicable U.S. GAAP.

.179 Changes in the sum of the fair value of financial assets and the carrying value of nonfinancial assets attributable to the beneficial interests (other than beneficial interests that represent compensation for services) owned by the reporting entity would be recognized in the consolidated statement of comprehensive income of the reporting entity.

.180 An entity that consolidates a collateralized financing entity would not be permitted to measure the financial liabilities at fair value under the fair value option regardless of whether the reporting entity elects to apply the measurement guidance under this proposed ASU.

.181 The amendments in this proposal would be effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. For nonpublic entities, the amendments would be effective for fiscal years beginning after December 15, 2014, and interim and annual periods after that date. Early adoption would be permitted. The proposed effective date will be redeliberated after the Emerging Issues Task Force considers stakeholder feedback on this proposed ASU.

Going Concern

.182 In June 2013, FASB issued proposed ASU *Presentation of Financial Statements (Topic 205): Disclosure of Uncertainties about an Entity's Going Concern Presumption*. Under U.S. GAAP, financial statements are prepared under the inherent presumption that the reporting entity will be able to continue as a going concern (that is, the entity will continue to operate such that it will be able to realize its assets and meet its obligations in the ordinary course of business [the going concern presumption]). The going concern presumption is critical to financial reporting because it establishes the fundamental basis for measuring and classifying assets and liabilities.

.183 Financial statements are prepared under the going concern presumption unless and until an entity's liquidation is imminent. When liquidation is imminent, an entity starts applying the liquidation basis of accounting as described in FASB ASC 205-30.

.184 Even before an entity's liquidation is imminent, there may be uncertainties about an entity's ability to continue as a going concern and, therefore, about its going concern presumption (going concern uncertainties). Currently, there is no guidance in U.S. GAAP about management's responsibilities in evaluating or disclosing going concern uncertainties or when and how going concern uncertainties should be disclosed in an entity's financial statement footnotes. U.S. auditing standards and federal securities laws require that an auditor evaluate whether substantial doubt exists about an entity's ability to continue as a going concern for a reasonable period of time. Auditing standards also require auditors to assess the possible financial statement effects, including the adequacy of disclosures on uncertainties about the entity's ability to continue as a going concern for a reasonable period of time as described in AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), or the PCAOB's AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).

.185 FASB received input indicating that the lack of guidance in U.S. GAAP and the varying interpretations of when and how going concern uncertainties should be disclosed under the auditing standards, resulting in diversity in the timing, nature, and extent of existing footnote disclosures. The proposed amendments in this ASU are intended to provide preparers with guidance in U.S. GAAP about management's responsibilities for evaluating and disclosing going concern uncertainties and, thereby, reduce existing diversity in footnote disclosures. In doing so, FASB believes that the proposed amendments also would improve the timeliness and the quality of footnote disclosures about going concern uncertainties.

.186 The proposed amendments would provide guidance in U.S. GAAP about management's responsibilities when evaluating an entity's going concern uncertainties and the timing and content of related footnote disclosures. An entity would evaluate going concern uncertainties by assessing the likelihood that the entity would be unable to meet its obligations as they become due within 24 months after the financial statement date.

.187 An entity would evaluate going concern uncertainties at each annual and interim reporting period and start providing footnote disclosures when it is either (*a*) more likely than not that the entity will be unable to meet its obligations within 12 months after the financial statement date without taking actions outside the ordinary course of business or (*b*) known or probable that the entity will be unable to meet its obligations within 24 months after the financial statement date without taking actions outside the ordinary course of business. When determining whether disclosures are necessary, an entity would assess information about conditions and events that exist at the date the financial statements are issued (or for a nonpublic entity, the date that the financial statements are available to be issued). Mitigating conditions and events also would be considered. When determining whether disclosures are necessary, however, an entity would not consider the potential mitigating effect of management's plans that are outside the ordinary course of business.

.188 When the previous disclosure threshold is met, an entity would disclose in the footnotes a description of (*a*) the principal conditions and events that give rise to the entity's potential inability to meet its obligations, (*b*) the possible effects those conditions and events could have on the entity, (*c*) management's evaluation of the significance of those conditions and events, (*d*) mitigating conditions and events, and (*e*) management's plans that are intended to address the entity's potential inability to meet its obligations. Disclosures may be less extensive in the early stages because available information may be limited. In subsequent reporting periods, disclosures may, depending on the circumstances, become more extensive as additional information becomes available about the conditions and events and management's plans.

.189 Additionally, the proposed amendments would require an entity that is an SEC filer to evaluate whether substantial doubt exists about its going concern presumption. If substantial doubt exists, the entity would disclose that determination in the footnotes. Substantial doubt would exist if, after assessing existing conditions and events and after considering all of management's plans (including those outside the ordinary course of business), the entity concludes that it is known or probable that it will be unable to meet its obligations within 24 months after the financial statement date. An entity that is not an SEC filer would not be required to evaluate or disclose whether substantial doubt exists about its going concern presumption but would be required to apply all the other disclosure requirements within the proposed amendments.

Insurance Contracts

.190 In June 2013, FASB issued proposed ASU *Insurance Contracts (Topic 834)*. Existing U.S. GAAP for insurance contracts have evolved over many years as a result of new insurance products and new contract terms and features. Those changes have resulted in multiple models that vary based on the nature of the insurance contract. Existing U.S. GAAP on insurance applies only to insurance entities and not to contracts issued by noninsurance entities that contain identical or similar economic characteristics to insurance contracts. That guidance has not been subject to comprehensive reconsideration by FASB before the beginning of this project.

.191 The guidance in this proposed ASU would apply to all entities that issue insurance contracts as defined in this proposed ASU (including entities other than insurance companies) or that hold reinsurance contracts, unless those contracts are specifically excluded from the scope of this proposed ASU. The guidance in this proposed ASU would not apply to the holder (that is, policyholder) of insurance contracts unless the contract is a reinsurance contract. The extent of the effect on an individual entity would depend on the significance of insurance contracts issued or reinsurance contracts held to the entity's operations and financial position.

.192 The guidance in this proposed ASU would supersede the requirements in FASB ASC 944, *Financial Services—Insurance*, which currently apply to insurance entities.

.193 The guidance in this proposed ASU would require an entity to measure its insurance contracts under one of two measurement models, referred to as the *building block approach* (for most life, annuity, and long-term health contracts) and the premium allocation approach (for most property, liability, and short-term health contracts).

.194 Under the guidance in this proposed ASU, contracts accounted for using the building block approach generally would be measured in a way that portrays a current assessment of the insurance contract. That measurement has the following two components:

- The present value of the unbiased probability-weighted mean of the future net cash flows (expected value) that the entity expects in fulfilling the contract
- A margin representing profit at risk, which is deferred and recognized as income as the uncertainty in the cash flows decreases

.195 An entity applying the premium allocation approach would initially measure its liability for remaining coverage as the contractual premiums that are within the boundary of the existing contract. In subsequent periods, the entity would reduce the measurement of the liability for remaining coverage on the basis of the expected timing of incurred claims and benefits and would recognize the amount of that reduction as insurance contract revenue. When insured events occur, an entity generally would measure a separate liability for incurred claims as the expected value of future cash flows to settle the claims and related expenses.

.196 The guidance in this proposed ASU generally would require an entity to present the following in net income:

- Insurance contract revenue:
  - For the building block approach—over the coverage and settlement periods as the obligation to provide coverage and other services are satisfied.
  - For the premium allocation approach—over the coverage period on the basis of the expected timing of incurred claims.

- Claims and expenses as they are incurred, and for contracts measured using the building block approach, changes in assumptions regarding expected cash flows.
- Interest expense using the discount rates determined when the contract was initially recognized. Those rates would be periodically reset for insurance contracts with discretionary participation features that change the expected cash flows.

Equity Method and Joint Venture Investments

.197 In April 2013, FASB issued proposed ASU *Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)*. Currently, under U.S. GAAP, a reporting entity that invests in a qualified affordable housing project may elect to account for that investment using the effective yield method if all the conditions in FASB ASC 323-740-25-1 are met. For those investments that are not accounted for using the effective yield method, FASB ASC 323-740-25-2 requires that those investments be accounted for in accordance with FASB ASC 970, *Real Estate—General*, which results in the investments being accounted for under either the equity method or the cost method. Some stakeholders have said that the conditions requiring the availability of tax credits to be guaranteed by a creditworthy entity and projected yield based solely on the cash flows from guaranteed tax credits to be positive in order to use the effective yield method are restrictive and, therefore, should be reconsidered. To these stakeholders, those conditions prevent many investments from qualifying for the use of the effective yield method, which they believe provides users with a better understanding of the returns from such investments.

.198 The amendments in this proposed ASU would permit reporting entities that invest in a qualified affordable housing project through a limited liability entity to elect to account for the investment using the effective yield method if all the following conditions are met:

- It is probable that the tax credits allocable to the investor will be available.
- The investor retains no operational influence over the investment other than protective rights, and, substantially, all the projected benefits are from tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment).
- The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive.
- The investor is a limited liability investor in the affordable housing project for both legal and tax purposes, and the investor's liability is limited to its capital investment.

.199 For those investments in qualified affordable housing projects not accounted for using the effective yield method, the investment would be accounted for as an equity method investment or cost method investment in accordance with FASB ASC 970-323.

.200 The decision to apply the effective yield method of accounting will continue to be an accounting policy decision, rather than a decision to be applied to individual investments that qualify for use of the effective yield method.

.201 A reporting entity would disclose information that enables users of its financial statements to understand the following:

- The nature of investments in qualified affordable housing projects
- The effect of the measurement of the investment in a qualified affordable housing project and the related tax credits on the financial position and results of operations of the reporting entity.

.202 To meet these objectives, a reporting entity may consider disclosures such as the following:

- The amount of affordable housing tax credits recognized during the year.

- For qualified affordable housing project investments accounted for using the equity method, the amount of investment income or loss included in pretax income.
- Whether the qualified affordable housing project is currently subject to any regulatory reviews and the status of such reviews (for example, investigations by the housing authority).
- Any commitments or contingent commitments (for example, guarantees or commitments to provide additional capital contributions), including the amount of equity contributions that are contingent commitments related to qualified affordable housing project investments and the year or years in which contingent commitments are expected to be paid.
- The amount and nature of the write-downs during the year resulting from the forfeiture or ineligibility of tax credits or other circumstances. These write-downs may be based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions, or other issues.

.203 The amendments in this proposed ASU would be applied retrospectively. Early adoption would be permitted. The effective date will be determined after FASB considers stakeholder feedback on the amendments to this proposed ASU.

Private Company Decision-Making Framework

.204 In April 2013, FASB issued proposed ASU *Private Company Decision-Making Framework: A Guide for Evaluating Accounting and Reporting for Private Companies*. In July 2011, FASB staff completed an assessment of (*a*) how and why the needs of users of private company financial statements may differ from the needs of users of public company financial statements and (*b*) how the cost-benefit considerations of financial reporting may vary between private companies and public companies. The assessment identified the following six significant factors that differentiate the financial reporting considerations of private companies and public companies:

- Types and number of financial statement users
- Access to management
- Investment strategies of equity investors
- Ownership and capital structures
- Accounting resources
- Learning about new financial reporting guidance

.205 In May 2012, the Financial Accounting Foundation Board of Trustees issued a final report, *Establishment of the Private Company Council*. The Private Company Council (PCC) was created to improve the standard-setting process for private companies. At the PCC's February 12, 2013, meeting, FASB and the PCC tentatively agreed on the criteria to be included in this guide for determining whether and in what circumstances there should be alternatives for private companies within U.S. GAAP. Using this guide, the PCC will develop, deliberate, and formally vote on proposed alternatives for private companies within U.S. GAAP. If endorsed by FASB, the proposed alternatives will be exposed for public comment. At the conclusion of the public comment process, the PCC will redeliberate the proposed alternatives and then submit them to FASB for a final decision on endorsement. FASB and the PCC also will use this guide to consider private company issues in standard-setting projects under active consideration on FASB's technical agenda.

Reporting Discontinued Operations

.206 In April 2013, FASB issued proposed ASU *Presentation of Financial Statements (Topic 205): Reporting Discontinued Operations*. Some stakeholders have said that too many disposals of assets qualify for discontinued operations presentation under FASB ASC 205-20. This results in financial statements that are not decision-useful for users and higher costs for preparers. The amendments in this proposed ASU would address these issues by changing the criteria for reporting discontinued operations and enhancing convergence of FASB's and the IASB's reporting requirements for discontinued operations.

.207 The amendments in this proposed ASU would change the requirements for reporting discontinued operations in FASB ASC 205-20, which would increase convergence of the requirements for reporting discontinued operations in FASB ASC 205-20 and International Financial Reporting Standard (IFRS) 5, *Non-current Assets Held for Sale and Discontinued Operations*. A *discontinued operation* would be either of the following:

- A component of an entity or a group of components of an entity that represents a separate major line of business or major geographical area of operations that either has been disposed of or is part of a single coordinated plan to be classified as held for sale in accordance with the criteria in FASB ASC 360-10-45-9
- A business that, on acquisition, meets the criteria in FASB ASC 360-10-45-9 to be classified as held for sale

.208 A *component of an entity* comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.

.209 The amendments in this proposed ASU would require additional disclosures about discontinued operations, including the following:

- The major income and expense items constituting the pretax profit or loss from a discontinued operation for the periods that the results of operations of the discontinued operation are reported in the statement where net income is reported
- The major classes of cash flows (operating, investing, and financing) of the discontinued operation for the periods that the results of operations of the discontinued operation are reported in the statement where net income is reported
- If the discontinued operation includes a noncontrolling interest, the pretax profit or loss attributable to the parent for the periods that the results of operations of the discontinued operation are reported in the statement where net income is reported
- A reconciliation of the major classes of assets and liabilities of the discontinued operation classified as held for sale that are disclosed in the notes to the financial statements to total assets and total liabilities of the disposal group classified as held for sale that are presented separately on the face of the statement of financial position for the initial period in which the disposal group is classified as held for sale
- A reconciliation of the major income and expense items from the discontinued operation that are disclosed in the notes to the financial statements to the after-tax profit or loss from the discontinued operation that is presented on the face of the statement where net income is reported for the periods that the results of operations of the discontinued operation are reported in the statement where net income is reported

.210 The proposed amendments would require a public entity to provide disclosures about a disposal of an individually material component of an entity that does not qualify for discontinued operations presentation in the financial statements, including the following:

- The pretax profit or loss attributable to the component of an entity for the period in which it is sold or is classified as held for sale and for all prior periods that are presented in the statement where net income is reported
- If the component of an entity includes a noncontrolling interest, the pretax profit or loss attributable to the parent for the period in which it is sold or is classified as held for sale and for all prior periods that are presented in the statement where net income is reported
- A reconciliation of the major classes of assets and liabilities of the component of an entity classified as held for sale that are disclosed in the notes to the financial statements to total assets and total

liabilities of the disposal group classified as held for sale that are presented separately on the face of the statement of financial position for the initial period in which the disposal group is classified as held for sale

.211 The proposed amendments would require a nonpublic entity to provide disclosures about a disposal of an individually material component of an entity that does not qualify for discontinued operations presentation in the financial statements, including the following:

- The pretax profit or loss attributable to the component of an entity for the period in which it is sold or is classified as held for sale
- If the component of an entity includes a noncontrolling interest, the pretax profit or loss attributable to the parent for the period in which it is sold or is classified as held for sale

.212 The proposed amendments would expand the disclosures about an entity's continuing involvement with a discontinued operation, including the following:

- The amount of any cash inflows (outflows) from (to) the discontinued operation
- Disclosures about a discontinued operation in which an entity retains an equity method investment after the disposal transaction

.213 Those disclosures would be required until the results of operations of the discontinued operation in which an entity retains continuing involvement are no longer separately presented in the statement where net income is reported.

.214 The effective date will be determined after FASB considers the feedback on the amendments in this proposed ASU. The proposed amendments would be applied prospectively to all disposals (or classifications as held for sale) of components of an entity that occur within annual periods beginning on or after the period of adoption, with earlier application permitted.

Financial Instruments

.215 In February 2013, FASB issued proposed ASU *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, and in April 2013, FASB issued proposed ASU *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities—Proposed Amendments to the FASB Accounting Standards Codification®*. The guidance in the first proposed ASUs focuses on creating a comprehensive framework for the classification and measurement of the financial instruments within its scope. An entity would determine the classification and measurement of a financial asset, upon initial recognition, by first considering whether the contractual terms of the asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (the contractual cash flow characteristics criterion). If so, an entity then would consider the business model in which the asset is managed, along with other financial assets, to determine its classification and measurement. An entity would be required to measure financial assets that do not meet the contractual cash flow characteristics criterion at fair value, with all changes in fair value recognized in net income.

.216 The second proposed ASU includes amendments to FASB ASC 825-10 to reflect FASB's decision to eliminate the fair value options in FASB ASC 825-10-15-4 for financial instruments that are not in the scope of the proposed ASU on financial instruments.

.217 FASB believes that retaining the unconditional fair value options has the potential to impair comparability and, thus, make financial statements less decision-useful. FASB further believes that such fair value options are no longer needed given its projects on financial instruments, insurance contracts, and revenue recognition. Thus, it decided to link the transition and effective date for eliminating these fair value options to those respective projects.

Leases

.218 In May 2013, FASB issued proposed ASU *Leases (Topic 842): a revision of the 2010 proposed FASB ASU,* Leases (Topic 840). The IASB and FASB have jointly developed a revised draft standard on leases. They developed the proposals in this revised exposure draft after considering responses to their discussion paper, *Leases: Preliminary Views*, which was issued in March 2009, and the IASB's initial exposure draft, *Leases*, and the proposed ASU, *Leases (Topic 840)*, which were both issued in August 2010.

.219 The core principle of the proposed requirements is that an entity should recognize assets and liabilities arising from a lease. This represents an improvement over existing lease requirements, which do not require lease assets and lease liabilities to be recognized by many lessees.

.220 In accordance with that principle, a lessee would recognize assets and liabilities for leases with a maximum possible term of more than 12 months. A lessee would recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the leased asset (the underlying asset) for the lease term.

.221 The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee would depend on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. For practical purposes, this assessment would often depend on the nature of the underlying asset.

.222 For most leases of assets other than property (for example, equipment, aircraft, cars, or trucks), a lessee would classify the lease as a Type A lease and would do the following:

- Recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments
- Recognize the unwinding of the discount on the lease liability as interest separately from the amortization of the right-of-use asset

.223 For most leases of property (that is, land or a building or part of a building), a lessee would classify the lease as a Type B lease and would do the following:

- Recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments
- Recognize a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, on a straight-line basis

.224 Similarly, the accounting applied by a lessor would depend on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. For practical purposes, this assessment often would depend on the nature of the underlying asset.

.225 For most leases of assets other than property, a lessor would classify the lease as a Type A lease and would do the following:

- Derecognize the underlying asset and recognize a right to receive lease payments (the lease receivable) and a residual asset (representing the rights the lessor retains relating to the underlying asset)
- Recognize the unwinding of the discount on both the lease receivable and the residual asset as interest income over the lease term
- Recognize any profit relating to the lease at the commencement date

.226 For most leases of property, a lessor would classify the lease as a Type B lease and would apply an approach similar to existing operating lease accounting in which the lessor would do the following:

- Continue to recognize the underlying asset
- Recognize lease income over the lease term, typically on a straight-line basis

.227 When measuring assets and liabilities arising from a lease, a lessee and a lessor would exclude most variable lease payments. In addition, a lessee and a lessor would include payments to be made in optional periods only if the lessee has a significant economic incentive to exercise an option to extend the lease or not to exercise an option to terminate the lease.

.228 The existing accounting model for leveraged leases would not be retained, and the proposals described for lessors would be applied to all leases currently accounted for as leveraged leases.

.229 For leases with a maximum possible term (including any options to extend) of 12 months or less, a lessee and a lessor would be permitted to make an accounting policy election, by class of underlying asset, to apply simplified requirements that would be similar to existing operating lease accounting.

.230 An entity would provide disclosures to meet the objective of enabling users of financial statements to understand the amount, timing, and uncertainty of cash flows arising from leases.

.231 On transition, a lessee and a lessor would recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach.

.232 FASB and the IASB will set the effective date for the proposed requirements when they consider interested parties' feedback on this revised exposure draft. They are aware that the proposals affect almost every reporting entity. Some of those entities have many leases, and the proposed changes to accounting for leases are significant. FASB and the IASB will consider these and other relevant factors when setting the effective date.

Revenue Recognition

.233 The income statement shows an entity's financial performance and position. However, revenue recognition requirements in U.S. GAAP differ from those in IFRSs, and both sets of requirements need improvement. U.S. GAAP comprises broad revenue recognition concepts and numerous requirements for particular industries or transactions that can result in different accounting for economically similar transactions. Although IFRSs have fewer requirements on revenue recognition, the two main revenue recognition standards, IAS 18, *Revenue*, and IAS 11, *Construction Contracts*, can be difficult to understand and apply. In addition, IAS 18 provides limited guidance on important topics such as revenue recognition for multiple-element arrangements.

.234 Accordingly, FASB and the IASB initiated a joint project to clarify the principles for recognizing revenue and develop a common revenue standard for U.S. GAAP and IFRSs that would

- remove inconsistencies and weaknesses in existing revenue requirements.
- provide a more robust framework for addressing revenue issues.
- improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
- provide more useful information to users of financial statements through improved disclosure requirements.
- simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

.235 To meet those objectives, FASB and the IASB have proposed amendments to FASB ASC and IFRSs, respectively.

.236 The core principle of this proposed guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

.237 To achieve that core principle, an entity would apply all the following steps:

- Step 1: Identify the contract with a customer.
- Step 2: Identify the separate performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to the separate performance obligations in the contract.
- Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

.238 FASB and the IASB have tentatively decided to require an entity to apply the revenue standard for reporting periods beginning on or after January 2017. That timing would ensure that for an entity providing two years of comparative annual financial information (in addition to information for the current year), the standard would be issued before the beginning of the earliest comparative annual period presented. FASB decided that early application would not be permitted. The IASB decided that early application would be permitted. The final document is expected in the third quarter of 2013.

Disclosure Framework

.239 The objective and primary focus of this project is to improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity's financial statements. Although reducing the volume of notes to financial statements is not the primary focus, FASB hopes that a sharper focus on important information will result in reduced volume in most cases.

.240 Achieving the objective of improving effectiveness will require development of a framework that promotes consistent decisions about disclosure requirements by FASB and the appropriate exercise of discretion by reporting entities. FASB also is considering whether, and, if so, how, to provide guidance to improve the organization, formatting, and style of notes to financial statements.

Private Company Council Proposals

.241 In June 2013, FASB endorsed three alternatives within U.S. GAAP that were proposed by the PCC. The proposals involve accounting for intangible assets acquired in business combinations, goodwill, and certain types of interest rate swaps. Exposure drafts are expected to be issued for public comment.

.242 The first proposal—derived from PCC Issue No. 13-01A, *Accounting for Identifiable Intangible Assets in a Business Combination*—modifies the requirement for private companies to separately recognize fewer intangible assets acquired in a business combination.

.243 The second proposal—derived from PCC Issue No. 13-01B, *Accounting for Goodwill Subsequent to a Business Combination*—would permit amortization of goodwill (the residual asset recognized in a business combination after recognizing all other identifiable assets acquired and liabilities assumed) and a simplified goodwill impairment model.

.244 The third proposal—derived from PCC Issue No. 13-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps*—would give private companies, other than financial institutions, the option to use two simpler approaches to accounting for certain types of interest rate swaps that are entered into by a private company for the purpose of economically converting its variable-rate borrowing to a fixed-rate borrowing.

.245 The effective dates will be determined after FASB and the PCC consider stakeholder feedback on the exposure drafts.

Resource Central

.246 The following are various resources that practitioners may find beneficial.

Publications

.247 Practitioners are encouraged to consider the following additional AICPA publications. Choose the format best for you—print, e-book, or online. Although the most current editions available at the date of writing of this alert are subsequently identified, you'll want the newest edition available at the time of purchase:

- Audit Guide *Analytical Procedures* (2012) (product no. AAGANP12P [paperback], AAGANP12E [eBook], or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2012) (product no. AAGRAS12P [paperback], AAGRAS12E [eBook], or WRA-XX [online])
- Audit Guide *Special Considerations in Auditing Financial Instruments* (2012) (product no. AAGAFI12P [paperback], AAGAFI12E [eBook], or AAGAFIO [online])
- Guide *Compilation and Review Engagements* (2013) (product no. AAGCRV13P [paperback], AAGCRV13E [eBook], or WRC-XX [online])
- Audit Guide *Auditing Revenue in Certain Industries* (2012) (product no. AAGREV12P [paperback], AAGREV12E [eBook], or WAR-XX [online])
- Audit Guide *Audit Sampling* (2012) (product no. AAGSAM12P [paperback], AAGSAM12E [eBook], or WAS-XX [online])
- Alert *Compilation and Review Developments—2012/13* (product no. ARACRV12P [paperback] or ARACRV12E [eBook])
- Alert *Independence and Ethics Developments—2012/13* (product no. ARAIET12P [paperback], ARAIET12E [eBook], or WIA-XX [online])
- *Internal Control—Integrated Framework: Executive Summary, Framework and Appendices, and Illustrative Tools for Assessing Effectiveness of a System of Internal Control* (3-volume set) (product no. 990025P [paperback] or 990025E [eBook]
- *Checklists and Illustrative Financial Statements for Corporations* (product no. ACKCOR12P [paperback] or WCP-CL [online])
- *U.S. GAAP Financial Statements—Best Practices in Presentation and Disclosure (formerly Accounting Trends & Techniques)* (product no. ATTATT12P [paperback] or WNG-XX [online])
- *IFRS Financial Statements—Best Practices in Presentation and Disclosure 2012/2013 (formerly IFRS Accounting Trends & Techniques)* (product no. ATTIFRS12P [paperback] or WIF-XX [online])
- *Audit and Accounting Manual* (2013) (product no. AAMAAM13P [paperback] or WAM-XX [online])
- *The Auditor's Report: Comprehensive Guidance and Examples* (product no. APAARMO [online])
- *The Engagement Letter: Best Practices and Examples* (product no. APAEGLO [online])
- Practice Aid *Related-Party Audit Considerations: A Case Study Approach* (product no. APARPS12P [paperback], APARPS12E [eBook], or APARPSO [online])
- Audit Risk Alert *Understanding the Responsibilities of Auditors for Audits of Group Financial Statements* (product no. ARAGRP13P [paperback], ARAGRPO [online], or ARAGRP13E [eBook])

Continuing Professional Education

.248 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *Accounting and Auditing Workshop: Latest Developments* (product no. 736189 [text]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *IFRS Certificate Program* (product no. 159770). Using a scenario-based series of courses with audio, video, and interactive exercises and case studies, this program will guide you through the concepts of each area of IFRSs.
- *Internal Control: Essentials for Financial Managers, Accountants, & Auditors* (product no. 731905 [text]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 745941 [text] or 181663 [DVD and manual]). Understanding the differences between IFRSs and GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and GAAP.
- *IFRS Essentials—GAAP Comparison/IFRS Essentials with GAAP Comparison: Building a Solid Foundation* (product no. 741604 [text]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.
- *FASB Industry Review—FASB Review for Industry: Targeting Recent GAAP Issues (2012/2013 Edition)* (product no. 730569). Comprehensive coverage of recent FASB and IASB pronouncements geared to the specific interests of the CPA in corporate management.

.249 Visit www.cpa2biz.com for a complete list of CPE courses.

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- Accounting and Auditing Update
- Small Business Accounting and Auditing Update
- Fair Value Accounting
- Accounting for Goodwill and Other Intangibles
- Uncertainty in Income Taxes
- Revenue Recognition in Today's Business Climate
- International Versus U.S. Accounting
- Fraud and the Financial Statement Audit
- Public Company Update
- SEC Reporting

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Accounting and Auditing Technical Hotline

.254 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. ET on weekdays. You can reach the Technical Hotline at 877.242.7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.255 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

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.256 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. You can also sign up for access to the entire library. Get access—anytime, anywhere—to the FASB ASC; the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, and *Accounting Trends & Techniques*; and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Codified Clarity Standards

.257 The best way to obtain the codified clarity standards is with a subscription to AICPA *Professional Standards* in the AICPA Online Professional Library. Although the individual SASs are available in paperback, this online codified resource is what you need to update your firm audit methodology and begin understanding how clarity standards change certain ways you perform your audits. Visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Specials/MostPopularProductGroups/AICPAResourceOnline/PRD~PC-005102/PC-005102.jsp for online access to AICPA *Professional Standards*.

.258 You can also get the clarified standards in paperback format. *Codification of Statements on Auditing Standards* is published each spring and includes the clarified auditing standards and the attestation standards. *Professional Standards*, which has the full complement of AICPA standards, is published each summer.

.259 The codification of clarified standards includes various resources:

- A preface, "Principles Underlying the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards"
- A glossary of terms defined in the standards
- An appendix describing the differences between GAAS and the ISAs
- A table mapping the pre-clarity AU sections to the clarified AU-C sections

Financial Reporting Center of AICPA.org

.260 CPAs face unprecedented changes in financial reporting. As such, the AICPA has created the Financial Reporting Center to support you in the execution of high-quality financial reporting. This center provides exclusive member-only resources for the entire financial reporting process and can be accessed at www.aicpa.org/frc.

.261 The Financial Reporting Center provides timely and relevant news, guidance, and examples supporting the financial reporting process. You will find resources for accounting, preparing financial statements, and performing various types of engagements, including compilation and review, audit and attest, and assurance and advisory.

.262 For example, the Financial Reporting Center offers a dedicated section to the Clarity Project. For the latest resources available to help you implement the clarified standards, visit the "Improving the Clarity of Auditing Standards" page at www.aicpa.org/SASClarity.

Additional Internet Resources

.263 The Internet covers a vast amount of information that may be valuable to auditors, including current industry trends and developments. Some of the more relevant sites for auditors include those shown in the following table:

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as the Accounting Standards Executive Committee)	Summaries of recently issued guides, whitepapers, and technical questions and answers containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/research/standards/compilationreview/arsc/pages/arsc.aspx
Committee of Sponsoring Organizations of the Treadway Commission	Information about the committee and the internal control framework developed by the committee	www.coso.org
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov

Website Name	*Content*	*Website*
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standard-setting activities in the international arena	www.ifac.org
Private Company Council	Information on the initiative to further improve FASB's standards-setting process to consider needs of private companies and their constituents of financial reporting	www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1176158985794
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov

[*The next page is 8061.*]

AAM Section 8013

Understanding the Responsibilities of Auditors for Audits of Group Financial Statements—2013

STRENGTHENING ENGAGEMENT QUALITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert (alert) is intended to help auditors understand and implement AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), which supersedes Statement on Auditing Standards No. 1 section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*), and paragraphs .12–.13 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*). The purpose of this alert is to provide guidance on implementing AU-C section 600, which is an auditing standard established by the Auditing Standards Board (ASB). Accordingly, this alert does not address any auditing standards established by the Government Accountability Office, the Public Company Accounting Oversight Board, or any other auditing standard setting body. Auditors of group financial statements that are subject to the requirements of another auditing standard setting body (in lieu of or in addition to) those established by the ASB are encouraged to read those standards in conjunction with this alert.

This publication is an *other auditing publication*, as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards.

In applying the auditing guidance included in an other auditing publication, the auditor should, using professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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The AICPA gratefully appreciates the invaluable assistance Philip J. Santarelli provided in creating this publication.

Feedback

As you encounter audit or accounting issues that you believe warrant discussion in an alert, please feel free to share them with us. Any other comments that you have about the alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

What Are Group Audits?

.01 Group audits involve the audit of financial statements that include the financial information of more than one component (group financial statements). AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), expands previous guidance related to using the work of other auditors to encompass audits of group financial statements. AU-C section 600 introduces a number of new terms, concepts, and requirements related to group audits that will significantly affect current practice (see paragraph .19 of this Audit Risk Alert [alert]). Because AU-C section 600 is much broader than previous guidance, it is important for auditors to fully understand the requirements therein. AU-C section 600 is effective for audits of group financial statements for periods ending on or after December 15, 2012.

.02 The following questions and answers point out some of the major changes in the new standard, which may assist auditors in recognizing when they are involved in an audit of group financial statements:

1. *What are group financial statements?* Group financial statements include the financial information of more than one component. The concept of group financial statements is broader than consolidated or combined financial statements because it encompasses business activities in addition to separate entities. Additionally, this standard applies in all audits of group financial statements regardless of whether different auditors are involved in the audit.

2. *What is a component?* A *component* is an entity or business activity for which group or component management prepares financial information that is required to be included in the group financial statements. A component may include, but is not limited to, subsidiaries, geographical locations, divisions, investments, products or services, functions, processes, or component units of state or local governments. Equity method investments are also components that are scoped into the standard. However, other investments using fair value measurements are generally not considered components.

3. *How are the previous concepts of* other auditor *and* principal auditor *changed in this standard?* The focus of the previous standard was the interaction between the auditors. AU-C section 600 changes that focus to the unique characteristics of a group reporting entity and how an auditor should obtain sufficient audit evidence to render an opinion on the group financial statements. An auditor who performs work on the financial statements, or financial information, of a component is now referred to as the *component auditor* rather than *an other auditor*. The *auditor of the group financial statements*, which encompasses the firm and group engagement team, including the group engagement partner, replaces the concept of the *principal auditor*. A member of the group engagement team may perform work on the financial information of a component for the group audit at the request of the group engagement team. When this is the case, such a member of the group engagement team is also a component auditor. Note that when the component is being audited by the group engagement team, the group engagement team is filling the role of the component auditor. Although members of the group engagement team may be filling the role of a component auditor, typically this will not add any additional performance requirements to the group audit other than, in some circumstances, the need to apply component materiality.

4. *Do the requirements change for making reference to the work of other auditors?* AU-C section 600 better articulates the degree of involvement required when reference is made to the audit of component auditors in the auditor's report on the group financial statements. It establishes certain conditions that

are necessary for the group engagement partner to make reference to a component auditor in the auditor's report on the group financial statements (see paragraph .111 of this alert for further discussion of these conditions). Moreover, AU-C section 600 clarifies that the group engagement partner is responsible for the opinion on the group financial statements, regardless of whether reference is made to component auditors. Additionally, AU-C section 600 establishes requirements that apply to all group audits regardless of whether reference is made to the work of the component auditor. These requirements expand the level of communication with the component auditors and the considerations of the group engagement partner when determining the acceptability of using the component auditor's work.

5. *Are there new procedures that are required when assuming responsibility for the work of other auditors?* Certain provisions of AU-C section 600 apply to all group audits regardless of whether reference is made to the audit of a component auditor in the auditor's report on the group financial statements. AU-C section 600 specifically articulates the procedures the group engagement team is required to perform when a component auditor is involved in the group audit. Additional specific procedures are applicable when the auditor of the group financial statements assumes responsibility for the work of a component auditor or is performing audit procedures on the components directly.

.03 This alert summarizes the new standard and provides implementation guidance for the auditor of the group financial statements. For component auditors, it also describes the specific matters that the group engagement team is required to communicate to the component auditor and to request that the component auditor also communicate with the group engagement team. However, auditors will need to read AU-C section 600, including its application material, in its entirety to fully understand its effect on current practice.

Organization of This Alert

.04 This alert is organized in the following major sections:

- *Introduction to the Clarified Statements on Auditing Standards*. Paragraphs .05–.20 of this alert provide an introduction to AU-C section 600 (paragraphs .05–.10 of this alert) that includes a discussion of the applicability (paragraphs .11–.17 of this alert) and objectives of AU-C section 600 (paragraph .18 of this alert), as well as definitions used in AU-C section 600 (paragraph .19 of this alert).
- *Overview of AU-C Section 600*. Paragraphs .21–.72 of this alert provide a detailed overview of AU-C section 600 using the same format as AU-C section 600. This section of the alert first presents a discussion of the group engagement team's responsibilities in all audits of group financial statements (paragraphs .22–.35 and .42–.56 of this alert), as well as the requirements applicable when the auditor of the group financial statements does not assume responsibility for, and makes reference to, the work of a component auditor (paragraphs .36–.41 of this alert). It then provides a discussion of the additional requirements in an audit of group financial statements when the auditor of the group financial statements assumes responsibility (that is, he or she does not make reference to the work of the component auditor in the auditor's report on the group financial statements) for the work of a component auditor (paragraphs .57–.72 of this alert).
- *How AU-C Section 600 Will Affect Practice*. Paragraphs .72–.161 of this alert first provide an overview of how specific sections of AU-C section 600 will generally affect audits of group financial statements (paragraphs .72–.103 of this alert) and then detail specific areas that will generally require additional consideration in the application of AU-C section 600 (paragraphs .104–.146 of this alert). This section of the alert also discusses considerations specific to audits of state and local governmental entities (paragraphs .147–.161 of this alert).
- *Resource Central*. Paragraphs .162–.172 of this alert provide a variety of resources to assist the auditor in understanding and implementing the new standards. Also found in this section are selected resources the auditor might find helpful in any financial statement audit and information on how these resources may be obtained or accessed.
- *Appendixes.* This alert contains five appendixes that include
  - answers to commonly asked questions related to the applicability and scope of AU-C section 600 issued by the AICPA as *Technical Practice Aids* (paragraph .173 of this alert);

- — a decision-making flowchart related to components included in AU-C section 600 (paragraph .174 of this alert);
- — two examples, one for a not-for-profit organization and one for a local government, related to applying group materiality and group performance materiality[1] to components (paragraph .175 of this alert);
- — four different examples involving various aspects of AU-C section 600 (paragraph .176 of this alert); and
- — additional resources the auditor may access online (paragraph .177 of this alert).

Introduction to the Clarified Statements on Auditing Standards

.05 The Auditing Standards Board (ASB) has substantially completed its Clarity Project to clarify existing generally accepted auditing standards (GAAS) to make them easier to read, understand, and apply. Statement on Auditing Standards (SAS) Nos. 117–127 have been issued in the clarity format and supersede all prior SASs except SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, AU sec. 322 and AU-C sec. 610A).[2]

.06 The clarified SASs articulate more clearly the objectives of the auditor and the requirements with which the auditor has to comply when conducting an audit in accordance with GAAS. SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification* (AICPA, *Professional Standards*), was issued in October 2011. As part of the clarity project, current AU section numbers have been renumbered based on equivalent International Standards on Auditing (ISAs). Guidance is located in "AU-C" section numbers instead of "AU" section numbers. Note that AU-C section numbers for clarified SASs with no equivalent ISAs have been assigned new numbers. The ASB believes that this recodification structure will aid firms and practitioners that use both ISAs and GAAS. All auditing interpretations corresponding to a SAS have been considered in the development of a clarified SAS and incorporated accordingly, and have been withdrawn by the ASB except for certain interpretations that the ASB has retained and revised to reflect the issuance of SAS No. 122. The effective date of the revised interpretations aligns with the effective date of the corresponding clarified SAS. The "AU-C" identifier was established to avoid confusion with references to existing "AU" sections, which will remain in AICPA *Professional Standards* through 2013. The AU-C identifier had been scheduled to revert back to the AU identifier at the end of 2013, by which time the previous AU sections would be superseded for all engagements. However, in response to user requests, the AU-C identifier will be retained indefinitely. The superseded AU sections are still scheduled to be removed from *Professional Standards* at the end of 2013.

.07 AU-C section 600 supersedes AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*), and paragraphs .12–.13 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*).

.08 SAS No. 127, *Omnibus Statement on Auditing Standards—2013* (AICPA, *Professional Standards*), was subsequently issued in January 2013 and, among other matters, amends AU-C section 600. These amendments relate to making reference to component auditors and are discussed further in paragraph .29 of this alert.

.09 AU section 543, written in 1972, primarily provided guidance for the auditor in deciding (*a*) whether to serve as the principal auditor and use the work of other auditors and (*b*) the form and content of the principal auditor's report in those circumstances. AU-C section 600 is more broadly focused on how to conduct an effective audit of group financial statements. In addition to the requirements of GAAS established in other SASs that are applied in audits of group financial statements (including but not limited to the risk assessment standards), it addresses special considerations that apply to group audits, in particular those that involve component auditors. Additionally, AU-C section 600 specifically articulates the procedures the group engagement team is required to perform when a component auditor is involved in the group audit. It also

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[1] *Materiality* and *performance materiality* are defined in AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*).

[2] Proposed Statement on Auditing Standards (SAS), *Using the Work of Internal Auditors*, which supersedes SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, AU sec. 322 and AU-C sec. 610A), was issued for exposure on April 15, 2013, with a comment period ending on July 15, 2013.

better articulates the degree of involvement required when reference is made to component auditors in the auditor's report on the group financial statements.

.10 The requirements of AU-C section 600 that may have the most impact on current practice include, but are not limited to, the following areas:

- Acceptance and continuance considerations
- The group engagement team's process to assess risk, including specific considerations affecting group financial statements
- The determination of materiality to be used to audit the group financial statements, including the materiality to be used for procedures related to components
- Exercising professional judgment in identifying components
- Identification of significant components and the related audit procedures to be performed
- Communications between the group engagement team and component auditors
- Assessing the adequacy and appropriateness of audit evidence by the group engagement team in forming an opinion on the group financial statements
- Consideration of factors when determining whether to make reference to the work of the component auditor(s)

Applicability of AU-C Section 600

.11 Paragraphs .01–.08 of AU-C section 600 broadly discuss responsibilities and requirements of the group engagement partner, the group engagement team, and the firm. In AU-C section 600, requirements to be undertaken by the group engagement partner are addressed to the group engagement partner. When the group engagement team may assist the group engagement partner in fulfilling a requirement, the requirement is addressed to the group engagement team. When it may be appropriate in the circumstances for the firm to fulfill a requirement, the requirement is addressed to the auditor of the group financial statements.

.12 AU-C section 600 applies to audits of group financial statements and addresses special considerations that apply to group audits, in particular those that involve component auditors. Accordingly, a critical aspect of this section is the identification of the components that are included in the group financial statements. Another important aspect is whether reference will be made to the audit of a component auditor in the auditor's report on the group financial statements. The requirements in paragraphs .51–.65 of AU-C section 600 are applicable to all components except those for which the auditor of the group financial statements is making reference to the work of a component auditor. All other requirements of AU-C section 600 apply regardless of whether the auditor of the group financial statements is assuming responsibility for the work of component auditors.

.13 An auditor may find AU-C section 600 useful, adapted as necessary in the circumstances, when he or she involves other auditors in the audit of financial statements that are not group financial statements. For example, in an audit of the financial statements of a single entity that does not prepare consolidated financial statements, an auditor may involve another auditor to observe the inventory count or inspect physical fixed assets at a remote location. In such situations, an auditor may adapt the guidance in AU-C section 600 with respect to obtaining an understanding of the other auditor's professional competence, communicating the work to be performed, or being involved in the work of the other auditor.

.14 The requirements of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), apply regardless of whether the group engagement team or a component auditor performs the work on the financial statements of a component. Certain requirements of AU-C section 220 are applicable to the group engagement partner. For example, the group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively possess the appropriate competence and capabilities. In addition, the group engagement partner is responsible for the direction, supervision, and performance of the group audit engagement. The group engagement partner is also responsible for deciding, individually for each component, to either

- assume responsibility for, and thus be required to be involved in, the work of a component auditor, insofar as that work relates to the expression of an opinion on the group financial statements, or
- not assume responsibility for the work of a component auditor and, accordingly, make reference to the audit of a component auditor in the auditor's report on the group financial statements.

.15 AU-C section 600 assists the group engagement partner in meeting the requirements of AU-C section 220 when component auditors perform work on the financial information of components.

.16 In a group audit, detection risk includes the risk that (*a*) a component auditor may not detect a misstatement in the financial information of a component that could cause a material misstatement of the group financial statements and (*b*) the group engagement team may not detect this misstatement. When the group engagement partner decides to assume responsibility for the work of a component auditor, AU-C section 600 explains the matters that the group engagement team considers when determining the nature, timing, and extent of its involvement in the risk assessment procedures and further audit procedures performed by component auditors on the financial information of the components. The purpose of this involvement is to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements.

.17 This alert provides an overview of the requirements of AU-C section 600 and provides guidance for applying those requirements in the audit of group financial statements. Among other information, AU-C section 600 provides the following information and examples (not included in this alert) that the group engagement team may find helpful:

- Illustrations of auditor's reports on group financial statements (exhibit A, "Illustrations of Auditor's Reports on Group Financial Statements")
- Examples of component auditor confirmations related to a group audit of the financial statements (exhibit B, "Illustrative Component Auditor's Confirmation Letter")
- Examples of matters about which the group team obtains an understanding in the audit of group financial statements (appendix A, "Understanding the Group, Its Components, and Their Environments—Examples of Matters About Which the Group Engagement Team Obtains an Understanding")
- Examples of conditions or events that may indicate risks of material misstatement of the group financial statements (appendix B, "Examples of Conditions or Events That May Indicate Risks of Material Misstatement of the Group Financial Statements")
- Required and additional matters the group engagement team may include in its letter of instruction (appendix C, "Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction")

Objectives of AU-C Section 600

.18 The objectives of the auditor as delineated in paragraph .10 of AU-C section 600 are to determine whether to act as the auditor of the group financial statements and, if so, to

- determine whether to make reference to the audit of a component auditor in the auditor's report on the group financial statements;
- communicate clearly with component auditors; and
- obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion about whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Definitions

.19 Paragraphs .11–.12 of AU-C section 600 define the following terms for purposes of GAAS:

component. An entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements.

component auditor. An auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit. A component auditor may be part of the group engagement partner's firm, a network firm of the group engagement partner's firm, or another firm.

component management. Management responsible for preparing the financial information of a component.

component materiality. The materiality for a component determined by the group engagement team for the purposes of the group audit.

group. All the components whose financial information is included in the group financial statements. A group always has more than one component.

group audit. The audit of group financial statements.

group audit opinion. The audit opinion on the group financial statements.

group engagement partner. The partner or other person in the firm who is responsible for the group audit engagement and its performance and for the auditor's report on the group financial statements that is issued on behalf of the firm. When joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team. AU-C section 600 does not, however, deal with the relationship between joint auditors or the work that one joint auditor performs in relation to the work of the other joint auditor. (*Group engagement partner* and *firm* refer to their governmental equivalents when relevant).

group engagement team. Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

group financial statements. Financial statements that include the financial information of more than one component. The term *group financial statements* also refers to combined financial statements aggregating the financial information prepared by components that are under common control.

group management. Management responsible for the preparation and fair presentation of the group financial statements.

group-wide controls. Controls designed, implemented, and maintained by group management over group financial reporting.

significant component. A component identified by the group engagement team (i) that is of individual financial significance to the group or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

.20 Reference to *the applicable financial reporting framework* means the financial reporting framework that applies to the group financial statements. Reference to *the consolidation process* includes the following:

- The recognition, measurement, presentation, and disclosure of the financial information of the components in the group financial statements by way of inclusion, consolidation, proportionate consolidation, or the equity or cost methods of accounting
- The aggregation in combined financial statements of the financial information of components that are under common control

Overview of AU-C Section 600

.21 AU-C section 600 provides guidance for when the auditor of the group financial statements assumes responsibility for the work of a component auditor and when the auditor does not assume responsibility for the work of a component auditor (that is, the group auditor makes reference to the audit of the component auditor in the auditor's report on the group financial statements). An audit of group financial statements involves establishing an overall group audit strategy and group audit plan (including identifying the components and the extent to which the group engagement team will use the work of component auditors). The decision whether the auditor's report on the group financial statements will make reference to the audit of a component auditor should be made by the group engagement partner. When the auditor of the group financial statements assumes responsibility for the work of a component auditor, no reference is made to the component auditor in the auditor's report on the group financial statements. Alternatively, when the auditor of group financial statements does not assume responsibility for the work of a component auditor, the auditor will make reference to the audit of the component auditor in the auditor's report on the group financial statements. Reference in the auditor's report on the group financial statements to the fact that part of the audit was conducted by a component auditor is not to be construed as a qualification of the opinion. Rather, such reference is intended to communicate

1. that the auditor of the group financial statements is not assuming responsibility for the work of the component auditor and

2. the source of the audit evidence with respect to those components for which reference to the audit of component auditors is made.

Whether reference is made to the component auditor does not change the objective of the auditor to "obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion about whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework" (paragraph .10 of AU-C section 600).

Responsibilities of the Group Engagement Team

.22 Paragraph .13 of AU-C section 600 states that the group engagement partner is responsible for the direction, supervision, and performance of the group audit engagement in compliance with professional standards, applicable regulatory and legal requirements, and the firm's policies and procedures. In addition, the group engagement partner is responsible for determining whether the auditor's report that is issued is appropriate in the circumstances.

Acceptance and Continuance

.23 Paragraphs .14–.17 of AU-C section 600 provide that the group engagement partner should determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained regarding the consolidation process and the financial information of the components on which to base the group audit opinion. The group engagement partner should evaluate whether the group engagement team will be able to obtain sufficient appropriate audit evidence, either through the (*a*) work of the group engagement team or (*b*) through the use of the work of component auditors, to act as the auditor of the group financial statements and to report as such on the group financial statements. However, the auditor's report on the group financial statements should not make reference to a component auditor unless the conditions discussed in paragraphs .29–.30 of this alert are met. In addition, the auditor of the group financial statements is required in accordance with AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), to agree upon the terms of the group audit engagement with management or those responsible for governance as appropriate.

.24 Restrictions imposed by group management may lead the group engagement partner to conclude that it will not be possible for the group engagement team to obtain sufficient appropriate audit evidence through the work of the group engagement team or through use of the work of the component auditors. If the possible effect of this inability will result in a disclaimer of opinion on the group financial statements, due to a scope limitation, the auditor of the group financial statements should

- not accept the engagement in the case of a new engagement;
- withdraw from the engagement if it is a continuing engagement (when possible under applicable law or regulation); or
- when the entity is required by law or regulation to have an audit, disclaim an opinion on the group financial statements after having performed the audit of the group financial statements to the extent possible.

Overall Audit Strategy and Audit Plan and Understanding the Group, Its Components, and Their Environments

.25 Paragraphs .18–.21 of AU-C section 600 require the group engagement team to

- establish an overall group audit strategy and to develop a group audit plan, which should be reviewed and approved by the group engagement partner;
- enhance its understanding of the group, its components, and their environments (including group-wide controls) obtained during the acceptance and continuance stage; and
- obtain an understanding of the consolidation process, including the instructions issued by group management to components.

.26 When establishing an overall group audit plan, AU-C section 600 also requires the group engagement team to assess the extent to which the group engagement team will use the work of component auditors and whether the auditor's report on the group financial statements will make reference to the audit of a component auditor. The understanding obtained by the group engagement team should be sufficient to (*a*) confirm or revise its initial identification of components that are likely to be significant and (*b*) assess the risks of material misstatement of the group financial statements, whether due to fraud or error.

Understanding a Component Auditor

.27 Regardless of whether reference will be made to the audit of a component auditor in the auditor's report on the group financial statements, paragraphs .22–.23 of AU-C section 600 place certain requirements on the group engagement team with respect to the component auditor. AU-C section 600 provides that in all audits of group financial statements, the group engagement team should obtain an understanding of the following:

- Whether a component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent[3]
- A component auditor's professional competence[4]
- The extent, if any, to which the group engagement team will be able to be involved in the work of the component auditor

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[3] When such standards are applicable to the group audit, the group engagement team is also required to determine that a component auditor is independent under *Government Auditing Standards* issued by the Comptroller General of the United States of the U.S. Government Accountability Office.

As discussed in paragraph .A46 of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), when the component auditor is not subject to the AICPA Code of Professional Conduct, compliance by the component auditor with the ethics and independence requirements set forth in the International Federation of Accountants Code of Ethics for Professional Accountants is sufficient to fulfill the component auditor's ethical responsibilities in the group audit.

[4] The group engagement team is also required to evaluate a component auditor's professional competence. Information for United States auditors can be obtained through the peer review system as well as the state societies or state boards of accountancy. For auditors in foreign jurisdictions, information may be obtained from the Public Company Accounting Oversight Board inspection process, through the professional organizations in the foreign jurisdiction, or through inquiry with global associations or networks with which the firm may be associated.

- Whether the group engagement team will be able to obtain information affecting the consolidation process from a component auditor
- Whether a component auditor operates in a regulatory environment that actively oversees auditors

.28 The group engagement team should obtain sufficient appropriate audit evidence relating to the financial information of a component without making reference to the audit of that component auditor in the auditor's report on the group financial statements or otherwise using the work of the component auditor when

- a component auditor does not meet the independence requirements that are relevant to the group audit or
- the group engagement team has serious concerns about whether a component auditor understands and will comply with the ethical requirements, including independence, that are relevant to the group audit or about a component auditor's professional competence.

Determining Whether to Make Reference to a Component Auditor in the Auditor's Report on the Group Financial Statements

.29 Paragraphs .24–.27 of AU-C section 600 state that it is the group engagement partner's responsibility to decide whether to make reference to a component auditor in the auditor's report on the group financial statements. If the group engagement partner decides not to make reference to the component auditor in the auditor's report on the group financial statements, the group engagement team is required to be involved in the work of the component auditor. The auditor's report on the group financial statements should not make reference to a component auditor unless (*a*) the group engagement partner has determined that the component auditor has performed an audit of the financial statements of the component in accordance with the relevant requirements of GAAS and (*b*) the component auditor has issued an auditor's report that is not restricted as to use.[5]

.30 When a component auditor has performed an audit of the component financial statements in accordance with auditing standards other than GAAS or, if applicable, auditing standards promulgated by the Public Company Accounting Oversight Board (PCAOB), the group engagement partner may evaluate, using professional judgment, whether such audit meets the relevant requirements of GAAS. For example, audits performed in accordance with ISA promulgated by the International Auditing and Assurance Standards Board (IAASB) are more likely to meet the relevant requirements of GAAS than audits performed in accordance with auditing standards promulgated by bodies other than the IAASB. The relevant requirements of GAAS are those that pertain to planning and performing the audit of the component financial statements and do not include those related to the form of the auditor's report. Additional guidance is provided in paragraph .A53 of AU-C section 600.

When Component Financial Statements are Prepared Under a Different Financial Reporting Framework

.31 If the component auditor reports on financial statements prepared in accordance with a different financial reporting framework than the group financial statements, there are two additional requirements in paragraph .26 of AU-C section 600 to be addressed before the group engagement partner can make reference to the component auditors' report. The first requirement is that the measurement, recognition, presentation, and disclosure criteria that are applicable to all material items in the component's financial statements under the financial reporting framework used by the component are similar to the criteria that are applicable to all material items in the group's financial statements under the financial reporting framework used by the group.

.32 There are several considerations when the group engagement partner is concluding on whether the relevant financial reporting framework is similar to the group's financial reporting framework. The greater

[5] SAS No. 125, *Alert That Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*, AU-C sec. 905), was issued in December 2011 and is effective for audits of financial statements for periods ending on or after December 15, 2012. The standard addresses the auditor's responsibility when required, or when the auditor decides, to include language that restricts the use of the auditor's written communication (audit report or other written communication) in a generally accepted auditing standards engagement.

the number of differences or the greater the significance of the differences between the criteria used for measurement, recognition, presentation, and disclosure of all material items in the component's financial statements under the financial reporting framework used by the component and the financial reporting framework used by the group, the less similar they are.

.33 Financial statements prepared and presented in accordance with International Financial Reporting Standards (IFRSs) and International Financial Reporting Standard for Small and Medium-sized Entities, as issued by the International Accounting Standards Board, are generally viewed as more similar to financial statements prepared and presented in accordance with accounting principles generally accepted in the United States of America (GAAP) than financial statements prepared and presented in accordance with jurisdiction-specific reporting frameworks or adaptations of IFRSs. In most cases, special purpose frameworks set forth in AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), are not similar to GAAP.

.34 The second requirement is that the group engagement team has obtained sufficient appropriate audit evidence for purposes of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group without the need to assume responsibility for, and thus be involved in, the work of the component auditor.

.35 Evaluating whether the financial statements of the component have been appropriately adjusted to conform with the financial reporting framework used by the group is based on a depth of understanding of the component's financial statements that ordinarily is not obtained unless the auditor of the group financial statements assumes responsibility for, and thus is involved in, the work of the component auditor. In rare circumstances, however, the group engagement partner may conclude that the group engagement team can reasonably expect to obtain sufficient appropriate audit evidence for purposes of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group without the need to assume responsibility for, and thus be involved in, the work of the component auditor.

Making Reference to a Component Auditor in the Auditor's Report on the Group Financial Statements

.36 When the group engagement partner decides to make reference to the audit of a component auditor in the auditor's report on the group financial statements, paragraph .28 of AU-C section 600 states that the group engagement team should obtain sufficient appropriate audit evidence with regard to such components by

- performing the procedures required under AU-C section 600, except for those that are only applicable when assuming responsibility for the work of a component auditor (that is, not making reference to the work of the component auditor in the auditor's report on the group financial statements), and
- reading the component's financial statements and the component auditor's report thereon to identify significant findings and issues and, when considered necessary, communicating with the component auditor in that regard.

.37 Paragraphs .29–.31 of AU-C section 600 state that if the group engagement partner decides to make reference to the audit of a component auditor, the auditor's report on the group financial statements should clearly indicate that the component was not audited by the auditor of the group financial statements but audited by the component auditor. The auditor's report on the group financial statements should clearly indicate the magnitude of the portion of the financial statements audited by the component auditor. If the group engagement partner decides to name a component auditor in the auditor's report on the group financial statements, (*a*) the component auditor's express permission should be obtained and (*b*) the component auditor's report should be presented with that of the auditor's report on the group financial statements.

.38 If the component auditor reported on component financial statements prepared in accordance with a different financial reporting framework, there are reporting requirements related to the auditor's report on the group financial statements. These include disclosing the following in the auditor's report on the group financial statements:

- The financial reporting framework used by the component
- That the auditor of the group financial statements is taking responsibility for evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group

.39 If the component auditor did not report that he or she conducted the audit in accordance with GAAS or PCAOB standards, and the component auditor performed additional audit procedures in order to meet the relevant requirements of GAAS, then the report on the group financial statements should also include

- the auditing standards used by the component auditor and
- that additional audit procedures were performed by the component auditor to meet the relevant audit requirements of GAAS.[6]

.40 Other factors for the group engagement partner's consideration in the decision whether to make reference to component auditors' reports on financial statements prepared in accordance with a different financial reporting framework include

- effectiveness of group-wide controls over the consolidation process, in particular the reconciliation to the group financial reporting framework.
- the understanding that the group engagement team has with respect to the other financial reporting framework, especially where there are complex transactions to evaluate.
- the understanding of the component and its operating environment.
- the ability of the group engagement team to obtain sufficient information to enable auditing the reconciliation to the group financial reporting framework.
- access to other professionals that have the expertise to advise the group engagement team with respect to the other financial reporting framework and required adjustments.

.41 When the component auditor has modified his or her opinion or has included an emphasis-of-matter or other-matter paragraph in his or her report, the auditor of the group financial statements should determine the effect this may have on the auditor's report on the group financial statements. When appropriate, the auditor of the group financial statements should modify the opinion on the group financial statements or include an emphasis-of-matter or other-matter paragraph in his or her report on the group financial statements.

Materiality

.42 In the context of a group audit, materiality is established for the group financial statements as a whole and component materiality is established for those components (1) on which the group engagement team will perform an audit or a review or (2) for which the auditor of the group financial statements will assume responsibility for the work of a component auditor who performs an audit or a review. Different materiality may be established for different components, and the aggregate of component materiality may exceed group materiality. Component materiality should be determined taking into account all components, regardless of whether reference is made to the audit of the component auditor in the auditor's report on the group financial statements. Paragraph .51 of AU-C section 600 provides additional requirements related to materiality that apply when the auditor of the group financial statements assumes responsibility for the work of a component auditor (see paragraph .57 of this alert).

[6] Exhibit A, "Illustrations of Auditor's Reports on Group Financial Statements," of AU-C section 600 provides examples of audit reports when making reference to component auditors reporting on financial statements prepared in accordance with a different financial reporting framework or conducting audits in accordance with different audit standards.

.43 Determining materiality is the responsibility of the group engagement team, and AU-C section 600 establishes requirements for the determination of materiality that are applicable to all audits of group financial statements. In all group audits, the following should be determined by the group engagement team:

- Materiality, including performance materiality, for the group financial statements as a whole when establishing the overall group audit strategy
- Materiality for particular classes of transactions, account balances, or disclosures in the group financial statements when, in the specific circumstances of the group, material misstatements of lesser amounts than materiality for the group financial statements as a whole could reasonably be expected to influence the economic decisions of the users taken on the basis of the group financial statements
- Component materiality for those components on which the group engagement will perform an audit or review or for which the auditor of the group financial statements will assume responsibility for the work of a component auditor who performs an audit or review
- The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements

.44 With respect to component materiality, as mentioned in the preceding list, the group engagement team should determine it by taking into account all components, regardless of whether reference is made to the audit of a component auditor in the auditor's report on the group financial statements. In a situation in which reference is being made to a component auditor's report, there is no requirement for the group auditor to communicate the apportioned component materiality to the component auditor. However, it may be helpful for the group auditor to understand the level at which the component auditor performed its procedures because the materiality assigned to such components may affect the materiality available for the rest of the components. To reduce the risk that the aggregate of uncorrected and undetected misstatements in the group financial statements exceed the materiality for the group financial statements as a whole, component materiality should be lower than the materiality for the group financial statements as a whole. However, the aggregate component materiality may, and is likely to, exceed group materiality. Component performance materiality should be lower than performance materiality for the group financial statements as a whole and may be determined by the group engagement team or the component auditor. Accordingly, when assuming responsibility for the component auditor's work, the group engagement team is required to evaluate the appropriateness of performance materiality at the component level.

Responding to Assessed Risks

.45 Appropriate responses to assessed risks of material misstatement for some or all account balances or classes of transactions may be implemented at the group level without involving the component auditor. Paragraph .33 of AU-C section 600 establishes requirements for the group engagement team to respond to the assessed risks of material misstatement that are applicable to all audits of group financial statements. In addition, paragraphs .52–.58 of AU-C section 600 provide additional requirements in this area that apply when the auditor of the group financial statements assumes responsibility for the work of a component auditor.

.46 The group engagement team should test, or have a component auditor test on the group engagement team's behalf, the operating effectiveness of group-wide controls over the consolidation process or the financial information of components when

- the auditor wishes to place reliance on the controls over the consolidation process rather than applying substantive audit procedures or
- substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

Consolidation Process

.47 As used in AU-C section 600, the *consolidation process* refers to both

1. recognition, measurement, presentation, and disclosure of financial information of components in the group financial statements through inclusion, consolidation, proportionate consolidation, or the equity or cost methods of accounting and

2. aggregation in combined financial statements of financial information of components under common control.

.48 The consolidation process may require adjustments to amounts reported in the group financial statements that do not pass through the usual transaction processing systems and, therefore, may not be subject to the same internal controls as other financial information. With respect to the consolidation process, paragraphs .34–.39 of AU-C section 600 provide that the group engagement team should

- obtain an understanding of group-wide controls and the consolidation process, including the instructions issued by group management to components.
- test, or request that the component auditor test, the operating effectiveness of group-wide controls if the nature, timing, and extent of the work to be performed on the consolidation process are based on an expectation that group-wide controls are operating effectively or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.
- design and perform further audit procedures to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process, including evaluating whether all components have been included in the group financial statements.
- evaluate the appropriateness, completeness, and accuracy of consolidation adjustments and reclassifications and evaluate whether any fraud risk factors or indicators of possible management bias exist.
- evaluate whether the financial information of a component that has not been prepared in accordance with the same accounting policies applied to the group financial statements has been appropriately adjusted for purposes of preparing and fairly presenting the group financial statements.
- determine whether the financial information identified in a component auditor's communication is the financial information that is incorporated in the group financial statements.
- evaluate whether appropriate adjustments have been made to the financial statements of any component (in accordance with the applicable financial reporting framework) with a financial reporting period-end that differs from that of the group.

Subsequent Events

.49 Recognition or disclosure of subsequent events affecting the group financial statements is the responsibility of group management and likewise the responsibility of component management in the component financial statements. However, paragraph .40 of AU-C section 600 requires the group engagement team, or the component auditors performing audits on financial information of components, to perform procedures related to subsequent events affecting components. Specifically, the group engagement team or the component auditors should perform procedures designed to identify events at components that occur between the dates of the financial information of the component and the date of the auditor's report on the group financial statements that may require adjustment to, or disclosure in, the group financial statements. Paragraph .59 of AU-C section 600 provides additional requirements related to subsequent events that apply when the auditor of the group financial statements assumes responsibility for the work of a component auditor.

Communication With a Component Auditor

.50 Paragraphs .41–.42 of AU-C section 600 require certain communications between the group engagement team and the component auditor in all group audits (discussed subsequently) and additional communications when the auditor of the group financial statements assumes responsibility for the work of a component auditor (see paragraphs .67–.68 of this alert). The group engagement team should communicate its requirements to a component auditor on a timely basis. This communication should include the following:

1. A request that the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, confirm that the component auditor will cooperate with the group engagement team.
2. The ethical requirements relevant to the group audit and, in particular, the independence requirements.
3. A list of related parties prepared by group management and any other related parties of which the group engagement team is aware. (The group engagement team should request the component auditor to communicate on a timely basis related parties not previously identified by either group management or the group engagement team. Additionally, the group engagement team should identify such additional related parties to other component auditors.)
4. Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor.

.51 In addition, the group engagement team should request a component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. This communication should include the following:

1. Whether the component auditor has complied with ethical requirements relevant to the group audit, including independence and professional competence
2. Identification of the financial information of the component on which the component auditor is reporting
3. The component auditor's overall findings, conclusions, or opinion

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

.52 When the group engagement team concludes that sufficient appropriate audit evidence has not been obtained on which to base the group audit opinion, the group engagement team may (*a*) request a component auditor to perform additional procedures or (*b*) perform its own procedures on the financial information of the component. Paragraphs .43–.45 of AU-C section 600 include requirements for the group engagement team and the group engagement partner with respect to evaluating the sufficiency and appropriateness of the audit evidence obtained by the group engagement team and the component auditor. In addition, AU-C section 600 provides additional requirements in this area (see paragraph .69 of this alert) that apply when the auditor of the group financial statements assumes responsibility for the work of a component auditor.

.53 The group engagement team should evaluate the component auditor's communication and discuss significant findings and issues identified as a result of that evaluation with the component auditor, component management, or group management, as appropriate. In addition, the group engagement team should evaluate whether sufficient appropriate audit evidence has been obtained from (*a*) the audit procedures performed on the consolidation process and (*b*) work performed by the group engagement team and the component auditors on the financial information of the components on which to base the group audit opinion. The group engagement partner should evaluate the effect on the group audit opinion of any

- uncorrected misstatements either identified by the group engagement team or communicated by the component auditor and
- instances in which there has been an inability to obtain sufficient appropriate audit evidence.

Communication With Group Management and Those Charged With Governance of the Group

.54 Certain communications with group management and those charged with governance of the group are required by paragraphs .46–.49 of AU-C section 600 in all group audits (discussed subsequently) with additional communications required when the auditor of the group financial statements assumes responsibility for the work of a component auditor (see paragraph .71 of this alert). With respect to communications with group management and those charged with governance of the group, the group engagement team should do the following:

1. Communicate material weaknesses and significant deficiencies in internal control that are relevant to the group.
2. Communicate any fraud identified by the group engagement team or brought to its attention by the component auditor or information indicating a fraud may exist on a timely basis to the appropriate level of group management.
3. When a component auditor has been engaged to express an audit opinion on the financial statements of a component, request group management to inform component management of any matter of which the group engagement team becomes aware that may be significant to the financial statements of the component but of which component management may be unaware.
4. Discuss the matter with those charged with governance of the group if group management refuses to communicate matters in item 3 to component management. When the matters noted in item 3 remain unresolved, consider, subject to legal and professional confidentiality considerations, whether to

   a. advise the component auditor not to issue the auditor's report on the financial statements of the component until the matters are resolved or

   b. withdraw from the engagement.

.55 The group engagement team should communicate the following matters to those charged with governance of the group (in addition to any other matters required to be communicated by AU-C section 260, *The Auditor's Communication With Those Charged With Governance* [AICPA, *Professional Standards*], and any other relevant AU-C sections):

- An overview of the type of work to be performed on the financial information of the components, including the basis for the decision to make reference to the audit of a component auditor in the auditor's report on the group financial statements
- An overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on significant components
- Instances in which the group engagement team's evaluation of the work of a component auditor gave rise to concern about the quality of that auditor's work
- Any limitations on the group audit
- Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls, or others in which a material misstatement of the group financial statements has or may have resulted from fraud

Documentation

.56 Paragraph .50 of AU-C section 600 requires documentation of certain matters in all group audits (discussed subsequently) as well as additional documentation requirements when the auditor of the group financial statements assumes responsibility for the work of a component auditor (see paragraph .72 of this alert). The following matters should be documented by the group engagement team:

- An analysis of components indicating those that are significant and the type of work performed on the financial information of the components.
- Written communications between the group engagement team and the component auditors about the group engagement team's requirements.
- Those components for which reference to the reports of component auditors was made in the auditor's report on the group financial statements.
- For those components for which reference is made in the auditor's report on the group financial statements to the audit of a component auditor,
  - — the financial statements of the component and the report of the component auditor thereon.
  - — when the component auditor did not conduct the audit in accordance with GAAS or PCAOB standards, the basis for the group engagement partner's determination that the component auditor's work met the relevant requirements of GAAS.

Additional Requirements Applicable When Assuming Responsibility for the Work of a Component Auditor

> **Help Desk**: Information discussed in the following paragraphs applies only when the group engagement partner decides to assume responsibility and, therefore, not make reference to a component auditor in the auditor's report on the group financial statements. These requirements are in addition to those previously discussed that are applicable in all audits of group financial statements.

Materiality

.57 Paragraph .51 of AU-C section 600 states that the group engagement team should evaluate the appropriateness of performance materiality at the component level when assuming responsibility for the component auditor's work. AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), provides guidance on determining performance materiality for purposes of assessing the risks of material misstatement and to design further audit procedures in response to assessed risks. Like component materiality, component performance materiality should be lower than performance materiality for the group financial statements as a whole.

.58 In some situations, the component auditor will be issuing a separate report to meet a legal or regulatory requirement in a different jurisdiction. In such cases, it may be beneficial for the group engagement partner to obtain information on the materiality and performance materiality that the component auditor intends to use. Often this may be lower than what the group engagement partner would have allocated to a particular component. In those cases, the lower materiality may be used and the group engagement partner may consider this lower materiality when determining component materiality for other components, which may be higher, and bearing in mind that individual component materiality is less than group materiality.

Determining the Type of Work to Be Performed on the Financial Information of Components

.59 For components for which the group engagement partner decides to assume responsibility for the work of component auditors, paragraph .52 of AU-C section 600 states that the group engagement team should determine the

- type of work to be performed by the group engagement team or by component auditors on its behalf on the financial information of the components and
- nature, timing, and extent of its involvement in the work of component auditors.

.60 In order to plan the work to be performed with respect to components for which the group engagement partner decides to assume responsibility, it is first necessary to identify which of those components are significant components (those that are individually financially significant or likely to include significant risks of material misstatement of the group financial statements). The following paragraphs discuss the group engagement team's responsibilities with respect to both significant components and those that are not significant. Appendix B, "Decision-Making Flowchart," of this alert provides steps that auditors might find helpful when applying the requirements of AU-C section 600 related to components.

Significant Components

.61 For components that are significant due to their individual financial significance to the group, paragraphs .53–.54 of AU-C section 600 state that the group engagement team, or a component auditor on its behalf, should perform an audit of the financial information of the component (adapted as necessary to meet the needs of the group engagement team) using component materiality. For components that are significant because they are likely to include significant risks of material misstatement of the group financial statements due to their specific nature or circumstances, the group engagement team, or a component auditor on its behalf, should perform one of more of the following:

- An audit of the financial information of the component (adapted as necessary to meet the needs of the group engagement team) using component materiality
- An audit of one or more account balances, classes of transactions, or disclosures relating to the likely significant risks of material misstatement of the group financial statements (adapted as necessary to meet the needs of the group engagement team)
- Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements

.62 When the group engagement team is considering the types of procedures to perform and instructions for the component auditor, guidance found in AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*), may be helpful even if that section is not applicable to the specific engagement. Also, there is no requirement for the component auditor to issue a report on the procedures when the group auditor is assuming responsibility for the component auditor's work. The component auditor's communication with the group engagement team may take the form of a memorandum of work performed or a more formal auditor's report, adapted as necessary to meet the needs of the group engagement team. Alternatively, the group engagement team can review the component auditor's working papers to obtain sufficient understanding of the procedures performed in order to conclude on the sufficiency of the evidence obtained.

Components That Are Not Significant Components

.63 For components that are not significant components, paragraphs .55–.56 of AU-C section 600 state that the group engagement team should perform analytical procedures at the group level. When the group engagement team determines that sufficient appropriate audit evidence on which to base the group audit opinion will not be obtained from certain procedures[7] specified in AU-C section 600, the group engagement team should select additional components that are not significant (varying, over time, which individual components are selected, which will introduce unpredictability into the audit process), and perform (or request a component auditor to perform) one or more of the following:

- An audit of the financial information of the component (adapted as necessary to meet the needs of the group engagement team) using component materiality
- An audit of one or more account balances, classes of transactions, or disclosures (adapted as necessary to meet the needs of the group engagement team)

[7] Specifically identified procedures are (1) work performed on the financial information of significant components, (2) work performed on group-wide controls and the consolidation process, and (3) analytical procedures performed at the group level.

- A review of the financial information of the component (adapted as necessary to meet the needs of the group engagement team) using component materiality
- Specified audit procedures

In situations in which there are a number of other than significant components, the group engagement team may determine the types of procedures performed on different components over time. In doing so, an element of unpredictability can be brought into the process.

Involvement in the Work Performed by Component Auditors

.64 When a component auditor performs an audit or other specified audit procedures of the financial information of a significant component for which the auditor of the group financial statements is assuming responsibility for the component auditor's work, paragraphs .57–.58 of AU-C section 600 specify that the group engagement team should be involved in the risk assessment of the component to identify significant risks of material misstatement of the group financial statements. The nature, timing, and extent of this involvement are affected by the group engagement team's understanding of the component auditor but at a minimum should include the following:

- Discussing the component's business activities that are of significance to the group with the component auditor or component management
- Discussing the susceptibility of the component to material misstatement of the financial information due to fraud or error with the component auditor
- Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements

.65 Significant risks of material misstatement of the group financial statements may be identified in a component for which the auditor of the group financial statements is assuming responsibility for the work of the component auditor. In such circumstances, the group engagement team should evaluate the appropriateness of the further audit procedures to be performed in response to such identified risks. Additionally, the group engagement team should determine whether it is necessary to be involved in the further audit procedures (based on its understanding of the component auditor). This involvement can take a variety of forms, such as reviewing relevant parts of the component auditor's audit documentation or requesting responses to specific inquiries relevant to the component entity.

Subsequent Events

.66 Recognition or disclosure of subsequent events affecting the group financial statements is the responsibility of group management and likewise the responsibility of component management in the component financial statements. When component auditors perform work other than audits of the financial information of components at the request of the group engagement team, paragraph .59 of AU-C section 600 requires the group engagement team to request the component auditors to notify the group engagement team if they become aware of events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements that may require an adjustment to, or disclosure in, the group financial statements.

Communication With a Component Auditor

.67 When the auditor of group financial statements is assuming responsibility for the work of a component auditor, paragraphs .60–.61 of AU-C section 600 state that the communication should set out the work to be performed and the form and content of the component auditor's communication with the group engagement team. In the case of an audit or review of the financial information of the component, component materiality (and the amount[s] lower than the materiality for particular classes of transactions, account balances, or disclosures, if applicable) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements should also be included.

.68 The communication requested from the component auditor should contain additional communications when the auditor of the group financial statement is assuming responsibility for the work of a component auditor, including

- whether the component auditor has complied with the group engagement team's requirements.
- information on instances of noncompliance with laws or regulations at the component or group level that could give rise to material misstatement of the group financial statements.
- significant risks of material misstatement of the group financial statements, due to fraud or error, identified by the component auditor in the component and the component auditor's responses to such risks. The group engagement team should request the component auditor to communicate such significant risks on a timely basis.
- a list of corrected and uncorrected misstatements of the financial information of the component (misstatements below the threshold for clearly trivial misstatement need not be included).
- indicators of possible management bias regarding accounting estimates and application of accounting principles.
- a description of any identified material weaknesses and significant deficiencies in internal control at the component level.
- other significant findings and issues the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving
    - component management or employees having significant roles in internal control at the component level and
    - others that resulted in a material misstatement of the financial information of the component.
- any other matters that may be relevant to the group audit or that the component auditor wishes to draw to the attention of the group engagement team. This includes exceptions noted in the written representations that the component auditor requested from component management.

A group auditor may find it helpful to develop a standard instruction memorandum that can be tailored to the circumstances of each component.

Evaluating a Component Auditor's Communication and Adequacy of His or Her Work

.69 In accordance with paragraphs .62–.63 of AU-C section 600, the group engagement team should determine, based on the evaluation that the group engagement team is required by paragraph .43 of AU-C section 600 to make of a component auditor's communication, whether it is necessary to review other relevant parts of a component auditor's audit documentation. If the group engagement team concludes that the work of a component auditor is insufficient, the group engagement team should determine additional procedures to be performed and whether such procedures are to be performed by the component auditor or the group engagement team.

.70 The timeliness and quality of the communications with the component auditor are critical factors in enabling the group engagement team to conclude on the sufficiency of the component auditors' work. Communicating early in the engagement provides the ability for the group engagement team to request additional procedures or to perform additional procedures on their own.

Communication With Group Management and Those Charged With Governance of the Group

.71 Paragraph .64 of AU-C section 600 states that the group engagement team should determine which material weaknesses and significant deficiencies in internal control that component auditors have brought to the attention of the group engagement team should be communicated to group management and those charged with governance of the group.

Documentation

.72 Paragraph .65 of AU-C section 600 states that the group engagement team should include in the audit documentation the nature, timing, and extent of the group engagement team's involvement in the work performed by the component auditors on significant components, including, when applicable, the group engagement team's review of relevant parts of the component auditors' audit documentation and conclusions thereon.

How AU-C Section 600 Will Affect Practice

> **Help Desk**: The following paragraphs discuss, in general terms, how the requirements of AU-C section 600 affect audits of group financial statements. Paragraphs .73–.103 of this alert provide insights about how specific aspects of AU-C section 600 will generally affect audits of group financial statements. Specific considerations in the application of AU-C section 600 to all types of entities are discussed in paragraphs .104–.146 of this alert.

.73 Some auditors may not be significantly affected by the requirements of AU-C section 600 because they performed many of the required procedures on audit engagements prior to the implementation of this standard.

.74 It is important for the auditor to remember that the requirements of AU-C section 600 apply to all audits of group financial statements, which by definition are financial statements that include the financial information of more than one component. The requirements of AU-C section 600 related to materiality, consolidation, and selection of components and account balances for testing, for example, apply in all group audits regardless of whether the audit of a component auditor is referenced in the auditor's report on the group financial statements, or whether the group engagement team is performing audit procedures on the component directly without the involvement of other component auditors.

.75 If an auditor performs work on the financial information of a component that will be used as audit evidence for the group audit, that auditor is a component auditor. If an auditor performs work on the financial information of a component that will not be used as audit evidence for the group audit, that auditor is not considered a component auditor. For example, a subsidiary may require a statutory audit. If this subsidiary is insignificant to the group and the group engagement team decides that it is able to obtain sufficient appropriate audit evidence by performing analytical procedures at the group level and, therefore, does not plan to use the statutory audit work as audit evidence relating to the group's financial statements, the auditor performing the statutory audit is not considered a component auditor. Note that in such situations, it is not necessary to apply component materiality to such a component.

.76 AU-C section 600 makes a number of changes to previous practice related to auditing group financial statements, for example, when component auditors are involved in (*a*) auditing the entities included in the reporting entity or (*b*) performing audit procedures on any specified element, account, or item of a financial statement (such as a division, agency, or location). The changes to previous practice made by AU-C section 600 include not only nomenclature (see paragraph .19 of this alert) and new audit procedures, including additional communications between the group engagement team and component auditor(s), but also include additional requirements for the auditor of the group financial statements.

.77 These additional requirements require the group engagement team to gain an understanding of the internal control over the consolidation process or combination of the components into the group financial statements; assess the specific risks of material misstatement due to fraud or error related to the group; determine group materiality, including, as necessary, an assessment of group materiality at lower levels for specific account balances, classes of transactions (for instance, intercompany transactions), or disclosures; and determine component materiality when audit or review procedures are to be performed by the group engagement team or by component auditors for which the auditor of the group financial statements will assume responsibility for the component auditor's work.

General Practice Considerations

.78 The objectives of AU-C section 600 are to determine whether to act as the auditor of the group financial statements, and, if so, to (*a*) determine whether to make reference to the audit of a component auditor in the auditor's report on the group financial statements; (*b*) communicate clearly with component auditors; and (*c*) obtain sufficient appropriate evidence regarding the financial information of the components and the consolidation process to express an opinion about whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

.79 In many cases, component auditors may be from the same firm, or network of firms, as the auditor of the group financial statements. This may significantly affect how some firms plan and conduct audits of group financial statements. Similarly, management and those charged with governance of the group may also be management and those charged with governance of a component. At other times, the component auditor and the auditor of the group financial statements may be different firms, or management and those charged with governance of the group may be different from management and those charged with governance of a component. Implementing the requirements of AU-C section 600 may necessitate changes to firms' audit methodologies and quality control systems. For audits of group financial statements for periods ending on or after December 15, 2012, the audit strategy and audit plan of the group and component auditor will need to incorporate the requirements of AU-C section 600.

.80 Auditors may decide, but are not required, to modify the contents of the engagement letter and management representation letter for the requirements of AU-C section 600. For example, the group engagement partner might decide to include a section in the engagement letter noting the possible consequences if sufficient appropriate evidence cannot be obtained due to restrictions imposed by group management. Similarly, the group engagement partner may decide that additional representations from management might be necessary with respect to certain subsequent events at components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements. Additional guidance with regard to the engagement letter and management representation letter is provided, when applicable, in the following paragraphs.

.81 Because AU-C section 600 is part of the ASB's Clarity Project, some auditors may not be aware of the changes made to the requirements for audits of group financial statements. When a component auditor and the auditor of the group financial statements are not the same firm, the component auditor may not be aware of the requirements of AU-C section 600 until approached by the group engagement team. Likewise, the group engagement team may not be aware of the requirements until approached by a component auditor. As discussed in the following sections of this alert, there will be a number of changes in how group audits are performed under AU-C section 600. The majority of the changes directly affect the group engagement team, but there are direct and indirect effects on the component auditor as well. Auditors that expect to be auditors of group financial statements or component auditors involved in the audit of group financial statements may find it helpful to reach out to each other as soon as possible.

> **Help Desk**: A thorough understanding of AU-C section 600 and timely communication between the group engagement team and the component auditor regarding its requirements will help ensure a smooth transition from the prior standards to the requirements of AU-C section 600.

.82 Management and those charged with governance of the group or component may not yet be aware of the changes in audits of group financial statements as a result of AU-C section 600. The group engagement partner (or the group engagement team) and the component auditor may discuss, as soon as possible, the requirements of AU-C section 600 and the resulting changes in the planned scope and timing of the audit of the group financial statements. Explanations of the additional work that may be required, including the additional involvement in the work of component auditors, may be particularly important when components are identified as significant components based on their individual financial significance to the group. In these circumstances, AU-C section 600 requires the group engagement team, or a component auditor on its behalf, to perform an audit of the financial information of the component (adapted as necessary to meet the needs of the group engagement team) using component materiality.

.83 In addition, it may be helpful to explain components in the context of audits of group financial statements to component or group management and those charged with governance. This may be particularly important in those engagements when components identified by the group engagement team for purposes of the group financial statements differ from those considered components by group or component management for operating or financial reporting purposes. For example, the group engagement team may identify a specific location as a component because it uses a different information processing system than the other business activities included in the group financial statements. Group management may identify its business activities by line of business rather than locations with differing systems.

.84 As noted elsewhere in this alert, the group engagement team and the component auditor (when the component auditor is another firm) may include items in the engagement letter or management representation letter related to their respective responsibilities under AU-C section 600.

.85 The following are examples of items that, at the discretion of the auditor of the group financial statements, may be included in the engagement letter or items in previous engagement letters that may be modified or expanded:

- Changes in language to include the terms *group* and *component* when appropriate.
- Management of the group's responsibility to select and apply an appropriate financial reporting framework for the group.
- The group engagement team's responsibilities with respect to identifying components (including significant components) for purposes of the group financial statements.
- Overview of the type of work to be performed on the financial information of the components, including the basis for the decision to make reference to the audit of a component auditor in the auditor's report on the group financial statements.
- Clarification of the reporting responsibilities of the group engagement team and any component auditors to which reference is expected to be made in the auditor's report on the group financial statements.
- Overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components.
- Responsibilities of the group engagement team with respect to testing of group-wide controls.
- Matters regarding the instructions related to the consolidation process that may be issued by group management to components.
- Expected communications between the group engagement team and group management and those charged with governance of the group, as appropriate, related to any
  - — material weaknesses or significant deficiencies in internal control.
  - — fraud identified by the engagement team or brought to its attention by the component auditor or information indicating a fraud may exist.
  - — fraud or suspected fraud involving group management, component management, employees having significant roles in group-wide controls, or others in which a material misstatement of the group financial statements has or may have resulted from fraud.

- — instances in which the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work.
- — any limitations on the group audit (that is, access to information is restricted).

.86 Relevant management representations, or modifications to previous representations by management, may include, at the discretion of the auditor of the group financial statements, the following items:

- Changes in language in certain management representations to include the terms *group* and *component* when appropriate
- Acceptance of responsibility by group management or component management, as applicable in the circumstances, for preparing component financial information
- The copy of group management's instructions related to the consolidation process provided to the group engagement team represents the actual instructions issued to components
- Group and component management representations related to the consideration of subsequent events through the date of the group financial statements at the group and component levels

.87 AU-C section 600 uses the terms *financial information* and *component auditor*, which are broader in concept than the respective terms *financial statements* and *other auditors* that were found in prior standards. In addition, the term *component* is specifically defined and can encompass more than the subsidiaries, divisions, branches, components, or investments referenced in prior standards with respect to the work of other auditors. The term *component* is used differently in AU section 543 than it is in AU-C section 600. The broader concepts and more specific definitions in AU-C section 600 may affect the group audit strategy, group audit plan, or both, thereby resulting in fewer or more audit procedures performed by either the group engagement team or component auditor.

Determining Components

.88 In order to apply the requirements of AU-C section 600, it will be necessary for the group engagement team to identify the components that prepare financial information that is required, by the applicable financial reporting framework, to be included in the group financial statements. By definition, *components* are entities or business activities for which group or component management prepares financial information for inclusion in the group financial statements. The group engagement team obtains an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components. Based on this, the group engagement team may conclude that the financial information included in the group financial statements can be effectively audited in aggregate rather than as separate components. Also, see paragraphs .152–.158 of this alert for further discussion of this requirement and practice issue as it relates to the audits of state and local governmental entities.

.89 The group engagement team obtains an understanding of the structure of the group financial reporting system as part of the risk assessment procedures when gaining an understanding of the entity and its environment. This may necessitate that the group engagement team enhance its understanding of the group, its components, and their environments, including group-wide controls. The group engagement team is required to obtain an understanding of the consolidation process, including instructions issued by group management to component management.

.90 The group engagement team is required to identify components that are likely to be significant components. To that end, the group engagement team may find it helpful to consider the following questions when identifying components:

- Does group management aggregate information from other entities or business activities to be included in the group financial statements? If so, is the information aggregated by
    - — a parent and one or more subsidiaries, joint ventures, or investees accounted for by the equity method)?

  - a head office, one or more divisions or branches, or both?
  - function, process, product, or service?
  - groups of products or services or geographical locations?

- How does group management aggregate this information?
- Do the entities or business activities that are aggregated for the group financial statements use a common financial reporting system or separate systems?
- What controls are in place to reduce the risk that errors might occur in the aggregation process and not be detected or corrected in the group financial statements?
- What controls are in place at the separate entity or business activity level to reduce the risk that errors might occur and not be detected or corrected in the financial information that is aggregated in the group financial statements?
- Do the group financial statements include an investment accounted for under the equity method of accounting?

.91 Determining components (parent, subsidiaries, variable interest entities, component units of state or local governmental entities, and so on) that are included in the group financial statements will not likely present a major challenge for the group engagement team in a continuing engagement. However, the entity may be involved with certain entities or activities that are less obvious indicators of a component, including special purpose entities involved with nonprofit organizations, joint ventures, investments accounted for using the equity method of accounting,[8] employee retirement systems included in the component or group financial statements of state or local governments, investments in real estate investment trusts, and others. The auditor in a continuing engagement is typically aware of these other entities and should determine if they represent significant components for purposes of the group financial statements and document this decision process.

.92 Note that investments that are required to be reported at fair value normally would not be considered a component for purposes of AU-C section 600. For instance, investments in entities that are marked to fair value using the practical expedient provided in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820-10-35 would not be subject to the group audit procedures. Guidance for these circumstances can be found in AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*).

> **Help Desk**: The auditor may need to make additional inquiries of group management with respect to related entities and parties to conclude that all components are included in the group financial statements.

.93 Determining if a specific business activity represents a component for purposes of AU-C section 600 requires professional judgment. If an entity's financial reporting system organizes financial information by function, product or service, or geographical location for purposes of external financial reporting, such functions, products or services, or locations may represent components for purposes of AU-C section 600. For example, group management may use financial information for several locations that is aggregated using a separate system or process from that used to prepare the group financial statements. The group engagement team may identify the locations as components. When financial information about a function, product or service, or geographical location is first part of the group's financial reporting system and then disaggregated by group management for operating purposes, the group engagement team may consider such financial information in whole or part as a class of transactions rather than components.

[8] Paragraph .A2 of AU-C section 600 states that investments accounted for under the equity method constitute a component, and investments accounted for under the cost method may be considered components when the work and reports of other auditors constitute a major element of evidence for such investments. See appendix A, "Questions and Answers," of this alert for questions and answers related to equity method investments.

.94 Financial information classified by business activity for the group financial statements may represent the operations of a single legal entity or a number of legal entities. In such cases, the group engagement team may determine the component to be the business activity rather than the separate legal entities generating the activity. For example, the consolidated statement of comprehensive income may separately present revenues for major lines of business when revenues are generated by various subsidiaries. In this example, if the subsidiaries operate using similar systems or have similar controls, the group engagement team may identify the components as the lines of business rather than the subsidiaries that generated the revenues. If all other information on the consolidated statement of comprehensive income is presented at a group level, the group engagement team is not precluded from identifying the individual legal entities as components for purposes of performing the audit of the group financial statements.

.95 Group or component management may identify components for accounting purposes, operating purposes, or both and aggregate the related financial information differently for decision making purposes and for reporting in the group financial statements. It is the responsibility of group or component management, not the group engagement team, to identify and aggregate financial information that is required to be included in the group financial statements. The group engagement team may consider the type, quantity, and quality of the information available at these levels when identifying components for purposes of applying the requirements of AU-C section 600.

Determination of Significant Components

.96 After identifying the components in the audit of group financial statements, the group engagement team is required to determine if any of these components represent significant components. The group engagement team makes this determination based on whether the component is (*a*) of individual financial significance of the group or (*b*) likely to include significant risks of material misstatement (due to its specific nature or circumstances) of the group financial statements. Under the requirements of AU-C section 600, the group engagement team may identify entities or business activities as components or significant components that were not subject to audit procedures at that level in previous engagements under the prior standards. This may be the case in the audits of some state or local governmental entities that report pension and other post-retirement benefit plans in their fiduciary fund statements or in audits of entities that report equity method investments.

Components That Are Significant Components

> **Help Desk**: The group engagement team may determine that it is necessary to perform an audit (adapted as necessary to meet the needs of the group engagement team) of the financial information of one or more significant components. This may result in the group engagement team spending more time performing risk assessment or further audit procedures than in prior audits.

.97 Paragraphs .A6–.A8 of AU-C section 600 discuss ways the group engagement team may identify components that are individually financially significant. For example, applying a percentage to a chosen benchmark, such as group assets, liabilities, cash flows, revenues, expenditures, or net income, is described as a way to determine components that are individually financially significant. However, the group engagement team may determine that other methods or benchmarks are more appropriate based on the type of group entity as well as the specific facts and circumstances. For example, in audits of governmental entities, appropriate quantitative benchmarks for identifying significant components might include net costs or total budget. Qualitative considerations in audits of governmental entities may involve matters of heightened public sensitivity, such as national security issues, donor funded projects, or reporting tax revenue. Regardless of the type of group entity, the benchmarks or percentages used may change from one year to the next based on general or specific economic or operating conditions.

> **Help Desk**: A benchmark based on a percentage of assets may be different in the group audit of a not-for-profit organization than it is in the audit of a private sector entity. Likewise, net income may not be an appropriate benchmark to determine components that are financially significant to the group financial statements in the group audit of a government, not-for-profit organization, or employee benefit plan.

.98 It may be more difficult for the group engagement team to identify components that include risks of material misstatement that are significant to the group financial statements based on their specific nature or surrounding circumstances. Components with complex transactions from a business or accounting perspective may be identified as specific significant risks by the group engagement team. Such transactions might be those involving multiple or related parties, fair value measurements and disclosures, foreign currency, derivatives, alternative investments, and the like. In addition, a component might be considered significant (because it is likely to include significant risks of material misstatement) if it operates, for example, in a regulatory environment, if its business activities involve highly technical goods or services, or if it transacts business with a government entity that is subject to public records laws. For such significant components, AU-C section 600 allows the group engagement team to audit, or request a component auditor to audit, (adapted as necessary to meet the needs of the group engagement team) one or more account balances, classes of transactions, disclosures, or a combination of these in lieu of an audit of the component's financial information. The group engagement team may decide that this approach provides sufficient appropriate evidence to address specific significant risks that may be present in a component.

Audit Entities With Multiple Locations and Auditors With Multiple Offices

> **Help Desk**: AU-C section 600 may require audit firms auditing group financial statements of entities having multiple locations or audit firms having two or more offices involved in the audit of group financial statements to consider a number of factors in the group audit that may not have previously been considered.

.99 Requirements of AU-C section 600 may result in changes in determining the scope of audits of entities with multiple locations because the definition of a *component* encompasses not only entities but also business activities, which may be conducted at different locations. The audit of a single entity with multiple locations would not necessarily meet the definition of a *group audit* because the auditor may not consider the locations to be components. For example, a single corporate entity may own three coin-operated laundromats, each of them considered a division of the corporate entity. However, the transactions for all are maintained on one general ledger system, and all internal control over financial reporting is applied in the same manner to each location. In addition, none of the separate locations prepares financial information. In this situation, it is likely that the auditor may conclude that the locations are not *components* as defined in AU-C section 600.

.100 Additionally, AU-C section 600 may result in changes to the audit strategy or audit plan of group financial statements when a component auditor is part of the group engagement partner's firm.

Components That Are Not Significant Components

.101 When no component is identified as significant, it is possible that appropriate responses to assessed risks of material misstatement for some or all accounts or classes of transactions may be implemented at the group level, without the involvement of component auditors.

.102 AU-C section 600 requires the group engagement team to perform analytical procedures at the group level for any components that are not significant components. Depending on the circumstances of the engagement, the financial information of these components may be aggregated at various levels for purposes of the analytical procedures. The evidence from these analytical procedures corroborates the group engagement team's conclusions that no significant risks of material misstatement exist from the aggregated financial information of components that are not significant components. Therefore, the group engagement team may consider a number of factors when determining the aggregation level, as well as the nature, timing, and extent of the analytical procedures. Factors the engagement team may consider include, but are not limited to, group materiality, the risk of material misstatement of the group financial statements, and the nature and sufficiency of other audit evidence. For example, if the financial information of the components that are not significant components is at or near group materiality levels, the group engagement team may consider more in-depth or additional analytical procedures. Similarly, if the risk of material misstatement of the aggregated financial information of these components is low, the group engagement team may perform fewer analytical procedures or perform analytical procedures at a higher level.

.103 In situations in which no significant components have been identified, it is highly unlikely that the group engagement team will determine that analytical procedures at the group level are enough to obtain sufficient appropriate evidence to issue an audit report on the group financial statements. In these cases, as discussed in paragraph .63 of this alert, the group engagement team should assess what audit procedures could be applied, either to individual components or aggregations of components, in order to obtain sufficient audit evidence.

Specific Application Considerations—All Group Audits

Help Desk: The following paragraphs will discuss in detail the additional or expanded audit procedures that are required under AU-C section 600 in all group audits. See paragraphs .139–.146 of this alert for additional requirements that are only applicable when the group engagement partner decides to assume responsibility for the work of a component auditor.

.104 A number of additional audit procedures are required under AU-C section 600, regardless of whether the group engagement partner decides to make reference to a component auditor in his or her report on the group financial statements. In addition, certain requirements in prior standards are expanded under AU-C section 600. These additional or expanded audit procedures may necessitate additional documentation and are discussed in the following paragraphs.

Overall Audit Strategy and Audit Plan

.105 Due to the new definitions and requirements of AU-C section 600, the group engagement team's approach to developing an overall group audit strategy and group audit plan may differ from that of previous years. The new definitions of *component*, *significant component*, and *component auditor* may affect the audit strategy and audit plan differently than under prior standards. For example, components and their component auditors may be identified well in advance of the planned timing of the engagement in order to make certain that the communications required under AU-C section 600 are adequate and occur on a timely basis. In addition, components that are significant due to their individual financial significance to the group are required to be audited (adapted as necessary to meet the needs of the group engagement team). These components may or may not have been audited at the level contemplated in AU-C section 600 in previous engagements performed under prior audit standards.

Understanding the Group, Its Components, and Their Environments

.106 Because the group engagement team is required to consider the risks of material misstatement (due to error or fraud) of the group financial statements, risk assessment procedures are necessary in the following areas, regardless of whether a component auditor will be involved:

- Identifying components, including significant components
- Gaining an understanding of the components
- Understanding and identifying group-wide controls
- Considering whether the group engagement team, the component auditor, or both need to perform tests of the group-wide controls
- Understanding the consolidation process (including the instructions issued by group management to components) and considering procedures the group engagement team, the component auditor, or both may perform

Understanding a Component Auditor

.107 Prior standards simply required the principal auditor (now the auditor of the group financial statements) to satisfy him- or herself about the independence and professional reputation of the other auditor (now component auditor) and to adopt appropriate measures to properly coordinate his or her activities with those of the other auditor whether referencing them or not in his or her audit report. In addition to required procedures related to the component auditor's professional competence, AU-C section 600 requires the group engagement team to perform additional procedures in connection with the component auditor that are related to (*a*) professional ethics; (*b*) the extent of involvement, if any, of the group engagement team in the work of the component auditor; (*c*) obtaining information from the component auditor related to the consolidation process; and (*d*) the regulatory environment in which the component auditor operates. These additional procedures may provide the group engagement team with information that could affect the risk assessment process, audit conclusions, or both. Such additional effort may vary depending on whether a component auditor is another firm or a member of the same firm as the auditor of the group financial statements. As such, it is important for the group auditor, as early as possible, to begin the process of understanding the component auditors and the level of cooperation expected. Failing to do so could lead to delays and undue pressure on the completion of the group audit.

.108 In certain circumstances (see paragraph .111 of this alert), AU-C section 600 does not allow the group engagement team to use the work of the component auditor and, by extension, does not allow the auditor of the group financial statements to assume responsibility for, or make reference to, the work of the component auditor in the audit report on the group financial statements. In such circumstances, the group engagement team is required to obtain sufficient appropriate audit evidence related to financial information of the component, without making reference to the audit of the component auditor or otherwise using the work of the component auditor, which may affect the group audit strategy, group audit plan, or both. AU-C section 600 applies both when the group engagement partner decides to make reference to the work of a component auditor and when the group engagement partner decides to assume responsibility for the work of a component auditor. Depending on the specific circumstances and the requirements of AU-C section 600, additional effort on the part of the group engagement team may be necessary, for example, when the

- component auditor does not meet the independence requirements relevant to the group audit. (The group engagement team may not use the work of the component auditor in any circumstance.)
- group engagement team has less than serious concerns about the component auditor's understanding of and compliance with the relevant ethical requirements or his or her professional competence. (The group engagement partner may not make reference to the component auditors' report but may use the component auditor, with adequate supervision, to perform certain procedures for which the group auditor assumes responsibility.)
- component's financial statements are not prepared using the same financial reporting framework as the group financial statements. (The group engagement partner may make reference to the component auditors' report if (1) the financial reporting framework used has measurement, recognition, presentation, and disclosure criteria that are similar to the group financial reporting framework and (2) the group auditor takes responsibility for evaluating the appropriateness of the conversion adjustments and reports appropriately. Otherwise, the group auditor may use the component auditor to perform an audit or procedures for which the group auditor takes responsibility.)

- component auditor has not issued a report stating that he or she performed an audit on the financial statements in accordance with GAAS or in accordance with the standards promulgated by the PCAOB. (The group engagement partner may make reference to the component auditors' report if the group auditor is satisfied that the audit performed by the component auditor meets the relevant requirements of GAAS; otherwise, the group auditor may use the component auditor to perform an audit or procedures for which the group auditor takes responsibility.)
- component auditor issued an auditor's report that is restricted as to use.[9] (The auditor of the group financial statements may not make reference to the component auditors' report.)

Determining Whether to Make Reference to a Component Auditor in the Auditor's Report on the Group Financial Statements

.109 The group engagement partner determines whether to make reference to the work of a component auditor in the audit report on the group financial statements. In developing the group audit plan, the group engagement team assesses, among other things, whether the auditor's report on the group financial statements will make reference to the audit of a component auditor. The group engagement partner (or the group engagement team) is required to communicate to those charged with governance the basis for the decision to make reference and may discuss the effect of this decision on the group audit strategy, group audit plan, or both with group management or those charged with governance of the group early in the planning phase of the group audit. Paragraph .A21 of AU-C section 600 provides additional considerations in this area that are specific to governmental entities. See paragraph .159 in this alert for further discussion of this requirement and practice issue as it relates to the audits of state and local governmental entities.

.110 Requirements in AU section 543 focused on the involvement of other auditors and when the principal auditor was able to assume responsibility for the work of other auditors. The requirements of AU-C section 600 focus on performing a group audit, including when the auditor's report on the group financial statements may reference the audit of a component auditor. AU-C section 600 requires that the group engagement partner, having gained an understanding of each component auditor, should decide whether to make reference to the component audit. This decision may also be based on the work performed by the group engagement team related to the audit strategy and plan as well as the understanding obtained with respect to the group, its components, and their environments. Under prior standards, this decision may have been made based on whether (*a*) the financial statements of the component were material in relation to the financial statements as a whole or (*b*) the other auditor (now the component auditor) was within or outside the network of the principal auditor (now the group auditor).

> **Help Desk**: It's important that the group engagement team understand the group and its components, as well as the related assessed risks of material misstatement, in order to determine or evaluate whether the work of the component auditor will provide sufficient appropriate evidence to support the overall conclusion on the group financial statements.

.111 AU-C section 600 lists several conditions, summarized as follows, that should be met in order to make reference to the audit of a component auditor in the auditor's report on the group financial statements:

- The group engagement partner has determined that the component auditor performed an audit of the financial statements for the component in accordance with the relevant requirements of GAAS or, if applicable, auditing standards promulgated by the PCAOB. (Generally, this means complying with GAAS requirements related to planning and performing audits, rather than the form of the auditors' report. Audits conducted in accordance with ISA are more likely to comply with the relevant requirements.)
- The component auditor did not issue an auditor's report that was restricted as to use.[10]

[9] See footnote 4.
[10] See footnote 4.

- If the component financial statements were prepared using a different financial reporting framework than the group financial reporting framework, then the group auditor has determined that the component financial reporting framework has measurement, recognition, presentation, and disclosure criteria similar to those of the group financial reporting framework.
- The group engagement team has obtained sufficient appropriate audit evidence to enable it to determine that the reconciling adjustments necessary to convert to the group financial reporting framework are appropriate.

.112 The condition that component and group financial statements be prepared using the same financial reporting framework is not related to the type of entity. For example, group financial statements that combine for-profit entities and a not-for-profit entity that individually and collectively present financial information, as required by FASB, are considered to be prepared using the same financial reporting framework. Group financial statements of, for example, a state university using the financial reporting framework established by the Governmental Accounting Standards Board (GASB) and a not-for-profit entity using the financial reporting framework established by FASB are considered to be using the same financial reporting framework because GASB provides for the inclusion of component financial information prepared using a different financial reporting framework. However, group financial statements may consolidate an entity using the financial reporting framework established by FASB and an entity using the cash basis of accounting. In this case, the financial information prepared using the FASB financial reporting framework would not be considered to be presented using the same financial reporting framework as those entities using the cash basis of accounting. As such, the requirements noted in the preceding paragraph would be applicable.

.113 In certain group audit situations, (such as group audits of state and local governments with component units and not-for-profit organizations involving combined financial statements), components, at the component financial statement level, may be required to use a financial reporting framework that is different from the financial reporting framework used at the group financial statement level. See paragraphs .147–.161 of this alert for further discussion of this requirement and practice issue as it relates to the audits of state and local governmental entities.

.114 The auditor of the group financial statements is precluded from making reference to the work of a component auditor in the auditor's report on the group financial statements if the component auditor's report is restricted as to use. This condition may necessitate the group engagement team communicating with the component auditor early in the planning phase. If there is no requirement under GAAS for a component auditor to restrict the use of the report on the component, early communication with the component auditor may allow the component auditor to consider whether it is necessary to restrict the use of his or her report on the component's financial statements for other reasons.[11] If the group engagement partner is assuming responsibility for the component auditor's work and no reference is made, then a report on the component that is restricted as to use is not precluded from being considered as part of the group auditor's evidential matter.

.115 Requirements of AU-C section 600 are required to be applied in (*a*) audits of group financial statements and (*b*) compliance audits that may be required by federal, state, or local governmental regulations except for certain paragraphs of AU-C section 600, which are identified as not being applicable to a compliance audit in paragraph .A41 of AU-C section 935, *Compliance Audits* (AICPA, *Professional Standards*). A discussion of the requirements of the sections of AU-C section 600 that are applicable to a compliance audit is outside the scope of this alert.

.116 If any of the conditions discussed in paragraph .111 of this alert are not met, the auditor's report on the group financial statements cannot make reference to the work of the component auditor. In such circumstances, the auditor of the group financial statements assumes responsibility for the work of the component auditor. Therefore, the group engagement team may revise the group audit strategy, group audit plan, or both to perform additional audit procedures itself, or it may ask the component auditor to perform such procedures on its behalf. Additional time may be required to complete or to coordinate these additional

[11] See footnote 4.

procedures. Therefore, the group engagement partner may begin this decision process early in the audit planning phase of the group audit.

.117 When the group engagement partner decides to make reference to the audit of a component auditor in the auditor's report on the group financial statements, all of the provisions of AU-C section 600 apply except for those discussed in paragraphs .51–.65 of AU-C section 600. The requirements in those paragraphs are applicable to all components except those for which the auditor is making reference to the work of a component auditor. The group engagement team will need to be aware of the requirements that are applicable in each of these situations.

Materiality

.118 AU-C section 600 requires the group engagement team to determine materiality, including performance materiality, for (*a*) the group financial statements as a whole and (*b*) particular account balances, classes of transactions, or disclosures in certain circumstances. In addition, the group engagement team is required to determine materiality for components on which the group engagement team will perform, or for which the auditor of the group financial statements will assume responsibility for the work of a component auditor who performs, an audit or a review (adapted as necessary to meet the needs of the group engagement team).

.119 To implement these requirements, it will be necessary for the group engagement team to consider the following procedures:

- Identify all components.
- Determine which components the group auditor will be directly responsible for auditing.
- Determine which components will involve the use of a component auditor. For each of those, determine which
    - — the group auditor will accept the responsibility for the work of the component auditor.
    - — the group auditor will make reference to in the auditors' report on the group financial statements.
- Determine which components are significant.

.120 Based on the information gathered in the preceding steps, the group auditor should then determine what materiality will be applied to

- the significant components for which the group auditor will be directly responsible.
- the significant components for which the group auditor will take responsibility for the work of the component auditor that
    - — will be reviewed by the component auditor.
    - — will be audited or have audit procedures performed by the component auditor.
- any components that are other than significant for which review or audit procedures will be performed.

For those components to which the group auditor is making reference, consider the impact on applied materiality.

.121 Based on the process outline in the preceding paragraphs, the next step is to develop a rational approach for applying materiality. The complexity of the process will depend on the number and type of components and the extent to which component auditors will be involved. The process will require extensive judgment. See example 2, "Multinational Manufacturing Company," in appendix D, "Applying Group Materiality to Components," for a case study that explores various approaches to the process.

.122 The group engagement team is required to establish component materiality at a lower materiality than that for the group financial statements. Different materiality may be established for different components, and the aggregate of component materiality may exceed group materiality.

> **Help Desk**: AU-C section 600 does not require the group engagement team to communicate component materiality to the component auditor when reference to that component auditor will be made in the auditor's report on the group financial statements.

Responding to Assessed Risks

.123 In responding to the assessed risk of material misstatement, if the nature, timing, and extent of the work to be performed on the consolidation process or the financial information of the components is based on an expectation that group-wide controls are operating effectively, or when substantive procedures alone cannot provide sufficient appropriate evidence at the assertion level, the group engagement team is required in certain circumstances to test, or have a component auditor test on the group engagement team's behalf, group-wide controls over the (*a*) consolidation process or (*b*) financial information of the component. In other words, the control risk associated with the consolidation process or the financial information of a component is no different than the control risk associated with financial statement assertions in general. In order to place reliance on those controls, it is necessary to lower control risk sufficiently by testing the controls.

.124 These requirements may affect the planned nature, timing, and extent of the work to be performed because AU-C section 600 may result in the identification of components, or significant components, not identified as such in previous engagements. The engagement team may find it helpful to determine if changes to the nature, timing, and extent of the planned work are necessary early in the risk assessment process in order to avoid potential delays in completing any related further audit procedures.

Consolidation Process

.125 Specific procedures are required to be performed by the group engagement team or a component auditor on behalf of the group engagement team related to the consolidation process. The understanding of the consolidation process that the group engagement team obtains includes understanding the instructions issued by group management to components. Depending on the previous experience with the group, the group engagement team may find it helpful to review these instructions before they are disseminated to the components or early in the planning phase of the group audit. By reviewing the consolidation process instructions before they are disseminated, the group engagement team may be in a position to make recommendations to group management to improve the consolidation process. Additionally, such review may identify missing or ineffective consolidation controls that the group engagement team may consider when assessing the risk of material misstatement of the group financial statements. Items of interest may include the following:

- Reconciliations entries to the group financial reporting framework
- Foreign exchange adjustments
- Intracomponent accounts
- Related party adjustments
- Top side adjustments made to reflect acquisition accounting
- Reconciliation of component tax provisions to group tax provision

.126 The group engagement team may also determine if all component financial information is expected to be prepared in accordance with the same accounting policies applied to the group financial statements early in the planning phase. Early communication with component auditors regarding differences in the application of accounting policies may result in audit efficiencies later in the engagement. For example, a component may use an asset capitalization threshold that is different from that used in the group financial statements. To adequately address the risk of material misstatement in such cases, the group engagement team may find it necessary to perform additional audit procedures or ask a component auditor to perform such procedures on its behalf. It will be more efficient if such procedures can be done in conjunction with the related areas in the audit of the component financial statements. See paragraph .161 of this alert for further discussion of this requirement and practice issue as it relates to the audits of governmental entities.

Subsequent Events

.127 Under GAAP promulgated by both FASB and GASB, management is responsible for determining the effect, if any, that subsequent events will have on the group financial statements. This extends to subsequent events affecting group financial statements, including those events affecting components that occur between the dates of the component financial information and the date the group financial statements are issued or available to be issued. The time period for which group management is responsible for subsequent events in the group financial statements may differ from the time period component management is responsible for subsequent events in the component financial statements or financial information. This would be the case in a group audit of a governmental entity that reports another entity as a component unit in its basic financial statements when the entities have different fiscal years. Further, the time period through which component management is responsible for subsequent events may be different than that of the group or component auditor. AU-C section 600 requires the group engagement team or component auditors to perform procedures to identify events at the components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements.

> **Help Desk**: The group engagement team may put emphasis on audit procedures associated with subsequent events when components have a different reporting period than that covered by the group financial statements, or the component financial statements are issued at a different time than the group financial statements, because the risk of material misstatement of the group financial statements due to failure to properly account for subsequent events may be increased in such situations.

.128 AU-C section 600 will necessitate the group engagement team working closely with group or component management and with the component auditor in order to meet the professional responsibilities with respect to subsequent events. It will also likely call for the component auditor to work closer with component management. In some group audits, group management's ability to exercise control over component management may vary. This may create issues for the group engagement team and the component auditor in fulfilling the requirements of AU-C section 600 related to subsequent events. With respect to the subsequent event procedures, (*a*) the group engagement team may use the work of the component auditor, (*b*) both the group engagement team and the component auditor may perform procedures in this area, or (*c*) the group engagement team alone may perform procedures in this area. Regardless of the level of control group management may exercise over component management, the group engagement team and the component auditor have responsibilities for subsequent events under AU-C section 600.

> **Help Desk**: Early communication with group management regarding its responsibilities to identify events at components that occur between the dates of the component's financial information and the date group management evaluates subsequent events for purposes of the group financial statements may increase audit efficiency for the group engagement team.

.129 Significant differences may exist between the reporting periods of the group and the components, or there may be differences in the dates of the auditors' reports on the group and one or more of the components. Therefore, the group engagement team may find it helpful to review the reporting periods of the group and the various components as soon as possible. Because group management is responsible for evaluating subsequent events, coordination between the group engagement team and the component auditor with respect to audit procedures related to subsequent events may help avoid duplication. The responsibilities of the group engagement team and the component auditor related to subsequent events may be agreed on by all parties and documented in order to avoid confusion at a later date. In addition, the auditor of the group financial statements may expand or modify the engagement or management representation letters for both the components and the group as a result of the requirements of AU-C section 600 relative to subsequent events.

.130 In situations in which the group engagement partner is making reference to the component auditor, it may be difficult to obtain the component auditor's agreement to comply with a request to notify the group engagement team about subsequent events. Nevertheless, the group engagement partner is required to consider the effect of subsequent events on the group financial statements, including all components. The group engagement partner may be able to obtain sufficient appropriate audit evidence through working with group management; examining group files related to the components, minutes, and budgets; and making appropriate inquiries.

Communication With a Component Auditor

.131 AU-C section 600 requires timely communication between the group engagement team and the component auditor of certain specific items and also requires that the communications about the group engagement team's requirements be documented. The group engagement team may also ask the component auditor to provide written documentation of any or all communications that AU-C section 600 requires of the group engagement team with respect to the component auditor (that is, whether the component auditor complied with ethical requirements—independence and professional competence—relevant to the group audit). Both the group engagement team and the component auditor may find it helpful to have all communications between them be in writing. For example, the group engagement team may ask the component auditor to confirm certain matters in writing. See paragraph .161 of this alert for further discussion of this requirement and practice issue as it relates to the audits of state and local governments.

.132 Due to the nature of some of the required communications, the group engagement team may wish to communicate certain items to the component auditor as soon as possible. The group engagement team may communicate its requirements to a component auditor when either (*a*) the component auditor is planning the audit or review of the financial information of the component that will be included in the group financial statements for the group's current financial reporting period (particularly when the entities have different fiscal years) or (*b*) the group engagement team is planning the audit of the group financial statements (whichever is earlier). For example, communication of related party information between the group engagement team and the component auditor provides both auditors with information that may be useful in executing the audit plan.

.133 AU-C section 600 does not explicitly establish requirements for the component auditor in audits of group financial statements. However, the engagement team is required to request a component auditor to communicate certain matters to it (often in a letter of instruction) and to evaluate the component auditor's communication (as well as the adequacy of his or her work). If effective two-way communication does not exist between the group engagement team and the component auditor, a risk exists that the group engagement team may not obtain sufficient appropriate audit evidence. However, the nature of some of the information that the group engagement team is required to request (for example, fraud, material misstatements, findings, conclusions, and so on) may prevent the component auditor from communicating it to the group engagement team before the component auditor has issued his or her overall findings, conclusions, or opinion. The group engagement team may establish a mutually agreed-upon time frame for the component auditor for the engagement period. In addition, the group engagement team may expand the group engagement letter to communicate to management and those charged with governance of the group the responsibilities of the component auditor under AU-C section 600.

.134 Situations involving auditors of equity method investees may present challenges in communicating with the component auditor because group management may not have the ability to influence management of the equity method investee or their auditors. The lack of effective communication with the component auditors does not in and of itself prevent the group auditor from making reference. However, the requirement to obtain an understanding of the component auditor with respect to ethical requirements, including independence, professional competence, and operation in an environment with regulatory oversight, and information about the consolidation process remain. Although it is more difficult without cooperation, it is possible if the component auditor operates in the same jurisdiction to obtain publically available information to assist in complying with the requirements.

Evaluating the Sufficiency and Appropriateness of Audit Evidence

.135 Under AU-C section 600, the group engagement team is required to evaluate the component auditor's communications (see paragraphs .131–.134 of this alert) and to discuss significant findings and issues arising from this evaluation with the component auditor, component management, or group management, as appropriate. Therefore, the group engagement team may find it helpful to have an in-depth discussion with the component auditor to discuss the requirements and expectations of the group engagement team with respect to the quality and timeliness of the component auditor's communications. This may be done as part of the planning phase of the group audit or before the planning phase begins, depending on the facts and circumstances of the timing of the group and component audits.

.136 In some cases, the group engagement team's evaluation of the component auditor's communication may indicate that additional audit procedures are necessary to provide sufficient appropriate evidence on which to base the group audit opinion. Therefore, the group engagement team may ask the component auditor, to the extent possible, to provide his or her communications well in advance of the planned date of the auditor's report on the group financial statements.

Communication With Group Management and Those Charged With Governance of the Group

.137 Several communications between the group engagement team and group management and those charged with governance for the group are required by AU-C section 600. Some of these communications, by their very nature, may occur before the engagement begins and some as part of wrapping up the audit of the group financial statements. These communications will generally address new requirements of the group engagement team. Consequently, the group engagement partner (or group engagement team) may discuss the requirements of AU-C section 600 with group management and those charged with governance of the group before or when the planning phase of the audit of the group financial statements begins.

.138 AU-C section 600 requires, among other communications, the group engagement team to communicate to group management and those charged with governance of the group the basis for the decision to make reference to the audit of a component auditor in the auditor's report on the group financial statements. Management and those charged with governance of the group may ask the group engagement partner what factors were considered in determining whether to make reference to a component auditor. Therefore, the group engagement partner or group engagement team may wish to be prepared to explain this decision to group management and to those charged with governance of the group.

Additional Requirements Applicable When Assuming Responsibility for the Work of a Component Auditor

Help Desk: Paragraphs .139–.146 of this alert discuss the requirements of AU-C section 600 that are applicable only when the auditor of the group financial statements assumes responsibility for the work of the component auditor.

.139 Under AU-C section 600, the group engagement partner determines whether to make reference to a component auditor based on his or her understanding of each component auditor. In addition, AU-C section

600 provides that the component auditor should not be referenced in the auditor's report on the group financial statements unless certain conditions (see paragraph .111 of this alert) are met.

.140 When the auditor of the group financial statements assumes responsibility for the work of a component auditor (that is, there is no reference to the component auditor's work in the audit report on the group financial statements), AU-C section 600 provides for additional audit procedures specific to the component auditor's work. The new requirements of AU-C section 600 include both generic and specific procedures for significant components and those components that are not significant components as well as related documentation requirements.

> **Help Desk**: When the group engagement partner decides to assume responsibility for the work of a component auditor, AU-C section 600 requires a number of specific procedures that can be generally classified as relating to (1) involvement in the work performed by component auditors and (2) various required communications with a component auditor.

.141 AU-C section 600 requires that the group engagement team be involved in the risk assessment of a significant component, and the group engagement team's understanding of the component auditor affects the nature, timing, and extent of this involvement. AU-C section 600 describes minimum additional procedures that are required of the group engagement team primarily related to discussions with the component auditor and reviewing the component auditor's documentation of significant risks. These new requirements may result in the group engagement team spending more time than in previous engagements

- evaluating the risk of material misstatement,
- understanding the component auditor, and
- understanding the risk assessment done at the component level and the procedures the component auditor plans to perform to address them.

.142 When the auditor of the group financial statements assumes responsibility for the work of a component auditor who is performing an audit or review, there are communication requirements in addition to those required in all group audits. For example, the required written communication from the group engagement team to the component auditor requires communication of (*a*) component materiality; (*b*) the amount(s) lower than materiality for certain account balances, classes of transactions, or disclosures (if applicable); and (*c*) the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements. Determining and communicating these amounts early enough in the planning phase of the group audit may allow the component auditor to more adequately plan the nature, timing, and extent of his or her work on the financial information of the component.

.143 The group engagement team is required to request that the component auditor communicate some additional items in paragraph .61 of AU-C section 600 when the auditor of the group financial statements assumes responsibility for the work of the component auditor. Several of these items may affect the findings, conclusions, or opinion of the group engagement team related to the group audit. Consequently, the group engagement team and the component auditor may mutually agree upon a date by which this information will be communicated to the group engagement team. This provides the group engagement team with adequate time to evaluate the findings, conclusions, or opinion of the component auditor relative to the audit of the group financial statements.

.144 As discussed in preceding sections of this alert, AU-C section 600 requires the group engagement team to perform specific audit procedures related to significant components that may be considerably more extensive than those required or performed under prior standards when the auditor of the group financial statements is assuming responsibility for the work of a component auditor. For example, an audit of the financial information of a component, adapted as necessary to meet the needs of the group engagement team, is required for a component that is significant due to its individual financial significance to the group.

Performing, or having these procedures performed, may require additional time and involve additional expense on the part of the group engagement team, component auditor, or both than in previous engagements.

.145 There is no requirement in AU-C section 600 that the group engagement partner obtain an audit or other report from a component auditor when assuming responsibility. Although many component auditors may issue a report with respect to their procedures, it is not required. The group engagement team may satisfy itself as to the level of work performed with a memorandum or summary of procedures from the component auditor or through its own review of the component auditors' working papers and related inquiries. A group engagement team may develop its own standard report that it requests the component auditor to complete.

.146 In some cases, component auditors have developed an internal policy whereby they furnish a report to the group auditor in accordance with the guidance in AU-C sections 800 or 805 depending on the circumstances and the work performed. Although this is not a presumptive requirement of the standard, the guidance in those AU-C sections may be helpful for group auditors in developing their own reporting protocol.

Considerations Specific to Audits of State and Local Governmental Entities

> **Help Desk**: AU-C section 600 may have numerous implications for the auditor of governmental entities. Group and component situations may be created by the very nature of the reporting model for all levels of governmental entities. This section, however, discusses the implications AU-C section 600 may have for the auditor of a state or local governmental entity.

.147 GASB standards contain requirements for what is to be included in the state and local government financial reporting entity. Accordingly, the financial statements of state and local governments may include different legal entities or business activities and may have highly decentralized financial accounting or reporting systems. Furthermore, many of the different legal entities and business activities included in the governmental financial reporting entity may issue separate audited financial statements that are incorporated into the state or local government's basic financial statements. Therefore, AU-C section 600 will likely apply to many audits of state and local governments. The "Application and Other Explanatory Material" section of AU-C section 600 includes several references to requirements of AU-C section 600 that may warrant special consideration when auditing state and local governments. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance to assist auditors in auditing and reporting on those financial statements in accordance with GAAS. The guide will be updated for the clarity SASs, including the requirements of AU-C section 600, in 2013.

.148 AU-C section 600 applies to all audits of group financial statements, and because many state and local governments include component units in their financial statements, it is likely that AU-C section 600 may apply to a number of governmental entity audits.

.149 A number of areas in AU-C section 600 that may create challenges in implementing the requirements for all group audits have already been addressed in a general fashion in preceding sections of this alert. However, because the following areas are somewhat unique in audits of a state or local government's financial statements, additional discussion is provided in this section:

- Terms used in AU-C section 600 that are defined differently than certain similar terms used in the GASB literature
- Identification of *components* as defined in AU-C section 600 (see paragraph .A5 of AU-C section 600)
- Requirements to make reference to the audit of a component auditor in the auditor's report on the group financial statements (see paragraph .25 of AU-C section 600)

- The consolidation process, with respect to different accounting policies and different reporting periods (see paragraphs .37 and .39, respectively, as well as paragraph .A12 of AU-C section 600)
- Communication with a component auditor (see paragraphs .41–.42 of AU-C section 600)

Differences in Terminology

.150 The financial reporting framework for state and local governments uses terms and definitions that are similar to those used in AU-C section 600 but generally have a different meaning or context in the GASB literature. For example, GASB defines *component units* as legally separate organizations for which the elected officials of the primary government are financially accountable. Component units can also be other organizations for which the nature and significance of their relationship with a primary government are such that exclusion would cause the reporting entity's financial statements to be misleading. These separate legal entities are included in the primary government's basic financial statements (which may be group financial statements) as blended or discretely presented component units when certain conditions exist. However, *component units*, as defined by GASB, are not consistent with the definition of a *component* in AU-C section 600. The group engagement team may identify a component unit as a component under AU-C section 600, but it may also identify additional components because the definition of *component* in AU-C section 600 is broader than the GASB definition of *component unit*. For example, a major special revenue fund that is not a component unit but is required by GASB to be included in the governmental financial reporting entity's financial statements could, as defined by AU-C section 600, be identified by the group engagement team as a component that is a business activity.

.151 GASB defines *business-type activities* as those that are financed in whole or in part by fees charged to external parties for goods or services. Such activities, usually reported in enterprise funds, are an opinion unit for purposes of the government-wide financial statements. As discussed in AU-C section 600, business activities are those for which group or component management prepares financial information that is included in the group financial statements. In this context, the group engagement team may identify business-type activities in governmental financial statements as business activities; however, the existence of business-type activities does not necessarily indicate they are a component for purposes of applying AU-C section 600.

> **Help Desk**: The group engagement team will need to clearly understand the meaning of the terms used in AU-C section 600 and how they differ from the similar terms defined by GASB.

Identification of Components

> **Help Desk**: The auditor of the financial statements of a state or local government will need to understand the nature of the government's financial reporting entity, component units, and business activities, as well as the nature of any aggregated information, included in the government's financial statements in order to understand how, or if, the requirements of AU-C section 600 apply.

.152 A governmental financial reporting entity may represent a single governmental entity or a primary government and its component units, certain of which may be audited by different auditors or the same auditor. In addition, governmental component units may be an aggregation of several *components* as defined in AU-C section 600. Therefore, the group engagement team may identify *components* as defined in AU-C section 600 even if no component units are included in the reporting entity. Nothing precludes the group engagement team from aggregating either component units or components within a component unit or the primary government itself for purposes of reporting on the group financial statements. The group engagement team considers the composition of the governmental reporting entity, including its opinion units and auditors, to determine how AU-C section 600 applies. Auditors of state and local governmental entities may be government audit organizations, CPA firms and individuals, or both. See additional guidance in paragraph .A14 of AU-C section 600 related to considerations specific to governmental entities.

.153 Another unique feature of governmental entities that prepare their financial statements in conformity with the GASB financial reporting framework is that multiple reporting units are required to be included in the basic financial statements. AICPA Audit and Accounting Guide *State and Local Governments* discusses the various opinion units that the auditor considers and opines on separately in a state or local government financial statement audit. The auditor of the group financial statements, or a component auditor, may audit one or more opinion units. An opinion unit is not necessarily a component as described in AU-C section 600. For example, governmental and business-type activities are separate opinion units but, in a single general-purpose governmental entity using one financial accounting and reporting system for all its activities, may not necessarily be identified by the group engagement team as components.

.154 Some components included in a government's group financial statements may represent aggregated information from separate legal entities or *business activities* as defined in AU-C section 600. For example, the *business-type activities*, as defined by GASB and reported on the government-wide statements as an opinion unit, may be identified by the group engagement team as a component for purposes of the group financial statements. As such, this component would represent the aggregation of several enterprise activities or adjusted fund-level information.

.155 As mentioned, a component unit may be a component for purposes of AU-C section 600; however, a number of other, less easily identified components may exist within either the primary government or one of its component units (for purposes of the group financial statements). The group engagement team may apply the provisions of AU-C section 600 to the individual components or may conclude that it is more appropriate to identify components at aggregate levels for purposes of applying AU-C section 600. (Paragraphs .A3–.A4 of AU-C section 600 discuss levels of aggregation in components.) For example, the group engagement team may identify the utility fund of a general purpose government as a component rather than its separate business activities related to water, sewer, solid waste, and stormwater operations. Therefore, the group engagement team may spend additional time understanding the group, its components, and their environments in order to implement the requirements of AU-C section 600.

.156 The group engagement team may identify a number of components within the governmental financial reporting entity. However, business activities meet the definition of a *component* only if they represent business activities for which group or component management prepares financial information that is required by the GASB financial reporting framework to be included in the group financial statements of a state or local government. Business activities identified as components by the group engagement team may be those of the primary government or one or more of its component units.

> **Help Desk**: In group audits of state and local governments, the group engagement team may find it helpful to employ a "top down" approach to identifying components. An effective way to do this may be to ask group management what it considers to be components in the government's basic financial statements. For example, group or component management may aggregate information for the group financial statements using financial information that is prepared at a fund level based on the government's legal or administrative level of control. A key aspect of the definition of a *component* is the level at which group or component management prepares financial information for inclusion in the group financial statements.

.157 If only one auditor is responsible for reporting on all of the opinion units in the financial statements of a state or local governmental entity, the requirements of AU-C section 600 may or may not apply. The applicability of AU-C section 600 depends on whether more than one component is identified. Therefore, if more than one component is identified, the group engagement team is required to obtain an understanding of the group, its components, and their environments including group-wide controls (see paragraph .20*a* of AU-C section 600); establish a group audit strategy; and develop a group audit plan (see paragraph .18 of

AU-C section 600). This understanding should be sufficient to confirm or revise the group engagement team's initial identification of significant components and to assess the risks of material misstatement (due to error or fraud) of the group financial statements. On the other hand, if only one auditor is responsible for all of the opinion units in the financial reporting entity and no components are included, the group engagement team could conclude that the financial statements are not group financial statements. In this situation, the audit of the government entity itself is not a group audit.

.158 In cases in which one auditor reports on the primary government and other auditors report on certain component units, the requirements of AU-C section 600 apply in the context of the group and the components identified by the group engagement team. AU-C section 600 allows the group engagement team to use significant judgment in determining components. Therefore, the group engagement team may want to keep this process as straight forward and high level as possible to increase audit efficiency. For example, if group or component management considers the component units as a business activity and that business activity is managed and accounted for using different systems from the primary government, the group engagement team may identify the component units as *components* (as defined in AU-C section 600) for purposes of applying AU-C section 600.

> **Help Desk**: When evaluating business activities as potential components under AU-C section 600, the group engagement team may find it helpful to consider the level at which group or component management prepares financial information that is included in the group financial statements.

Reference to the Audit of a Component Auditor

.159 AU-C section 600 specifies conditions that should be met in order to make reference to a component auditor in the auditor's report on the group financial statements. One condition requires that if a component uses a different financial reporting framework than the group financial reporting framework, the measurement, recognition, presentation, and disclosure criteria of the components' financial reporting framework be similar to that used by the group. In some audits of governmental entities, this requirement may call for significant additional evaluation to determine if reference can be made to the work of a component auditor. To address the requirements, paragraph .A57 of AU-C section 600 provides that component financial statements are deemed to be in accordance with the applicable financial reporting framework when the applicable financial reporting framework provides for the inclusion of component financial statements that are prepared in accordance with a different financial reporting framework. For example, a governmental university prepares its group financial statements using the GASB financial reporting framework. The group financial statements include the financial statements of a foundation that is required by the GASB financial reporting framework to be included in the university's basic financial statements as a component unit. The foundation appropriately uses the FASB financial reporting framework and is audited by a component auditor. Assuming the other specific conditions are met, the auditor of the university's financial statements (group financial statements) is permitted to refer to the audit performed by the foundation's auditor (component auditor) because GASB provides for the inclusion of the foundation's FASB-based financial statements in the university's basic financial statements (see paragraph .A57 of AU-C section 600). As such, there would be no requirement to assess whether the component financial reporting framework was sufficiently similar to the group financial reporting framework. However, the group auditor is still required to evaluate the appropriateness of any adjustments to include the foundation's financial information in the university's financial statements.

Consolidation Process

.160 *Components*, as defined in AU-C section 600, in governmental group financial statements that are also component units for purposes of the reporting entity may have different management than that responsible for the group financial statements. Therefore, the financial information of a component may not be prepared in accordance with the same accounting policies applied to the group financial statements. For example, the period of availability used to recognize revenues by component management using the modified accrual basis of accounting may be different than that used by group management. Likewise, the asset capitalization threshold used by component management may be different from that used by group management. In such cases, the group engagement team may find it necessary to perform additional audit procedures or ask a component auditor to perform certain additional procedures on its behalf. This may be difficult in the audit of a governmental entity because the auditor of the primary government, acting as the auditor of the group financial statements, may have been appointed as a result of a competitive selection process with the scope of services and the related fees established for multiple years at the inception of the contract. In addition, this may be difficult when the auditor of the group financial statements does not have the jurisdictional authority to audit the component or when group management does not have effective or sufficient authority over the component. The group engagement team may determine that it is necessary in these situations to perform its own procedures on the financial information of such components. However, the group engagement team may be limited in the procedures it can perform unless the component is willing and able to engage the group engagement team.

> **Help Desk**: The requirements of AU-C section 600 may be applicable regardless of the circumstances surrounding the engagement of the auditor of the group financial statements. The group engagement team may work with group management and the component auditor to effectively apply the requirements of AU-C section 600.

Communication With a Component Auditor

.161 As mentioned in the preceding paragraph, auditors for governmental entities may have been appointed through a competitive selection process. The existence of numerous auditors who are often competitors may hinder communication between the auditor of the group financial statements (that is, the auditor of the primary government) and the auditor of a component unit (identified by the engagement team as a component for purposes of applying AU-C section 600). The group engagement team may take into consideration the circumstances surrounding the relationship between the group engagement team and the component auditor when planning the group audit and developing the group strategy and group audit plan.

Resource Central

.162 Additional information and resources related to the Clarity Project are available on the AICPA Financial Reporting Center website at www.aicpa.org/FRC.

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.163 Auditors may find the following publications useful. Choose the format that's best for you: online or print:

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- Audit and Accounting Guide *State and Local Governments* (2013) (product no. AAGSLG13P [paperback] or WGG-XX [online with the associated Audit Risk Alert]).
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- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 745941 [text] or 181663 [DVD and manual]). Understanding the differences between IFRSs and GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and GAAP.

.166 Visit www.cpa2biz.com for a complete list of CPE courses.

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.167 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $209 for a new subscription. Nonmembers pay $435 for a new subscription. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest include the following:

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.172 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

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Appendix A — Questions and Answers

The following questions and answers are found in paragraphs .01–.41 of TIS section 8800, "Audits of Group Financial Statements and Work of Others" (AICPA, *Technical Practice Aids*), and are included here to provide nonauthoritative guidance regarding the implementation of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*).

.01 Applicability of AU-C Section 600

Inquiry—Do the requirements of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), apply only when the auditor makes reference to the audit of another auditor in his or her report on the group financial statements?

Reply—No. AU-C section 600 applies to all audits of group financial statements. Certain requirements (detailed in paragraphs .50–.64 of AU-C section 600) are applicable to all components, except those for which the auditor of the group financial statements is making reference to the work of a component auditor. (See paragraph .08 of AU-C section 600.)

[Issue Date: November 2012.]

.02 Making Reference to Any or All Component Auditors

Inquiry—If the group engagement partner decides to make reference to one component auditor in the audit report on the group financial statements, is he or she required to make reference to all component auditors in that report?

Reply—No. The decision to make reference to the audit of a component auditor is made individually for each component auditor. The auditor of the group financial statements may make reference to any, all, or none of the component auditors. (See paragraphs .24 and .A52 of AU-C section 600.)

[Issue Date: November 2012.]

.03 Deciding to Act as Auditor of Group Financial Statements

Inquiry—What factors determine whether an auditor decides to act as the auditor of a group's financial statements?

Reply—The group engagement partner decides to act as the auditor of the group financial statements and report as such on the group financial statements upon evaluating whether the group engagement team will be able to obtain sufficient appropriate audit evidence through the group engagement team's work or use of the work of component auditors. Relevant factors in making this determination include, among other things, the (*a*) individual financial significance of the components for which the auditor of the group financial statements will be assuming responsibility, (*b*) extent to which significant risks of material misstatements of the group financial statements are included in the components for which the auditor of the group financial statements will be assuming responsibility, and (*c*) extent of the group engagement team's knowledge of the overall financial statements. (See paragraphs .15 and .A18 of AU-C section 600.)

In audits of state and local governments, additional factors to consider include (*a*) engagement by the primary government as the auditor of the financial reporting entity and (*b*) responsibility for auditing the primary government's general fund (or other primary operating fund). (See paragraph .A21 of AU-C section 600.)

[Issue Date: November 2012.]

.04 Factors to Consider Regarding Component Auditors

Inquiry—What factors might the group engagement partner consider when deciding to use the work of a component auditor and whether to make reference to the component auditor in the auditor's report on the group financial statements?

Reply—In all group audits, the group engagement team is required to obtain an understanding of the component auditor, and the group engagement partner uses this and his or her understanding of the component when deciding to use the work of a component auditor and whether to make reference to the component auditor in the auditor's report on the group financial statements. Factors affecting this decision include (*a*) differences in the financial reporting framework applied in preparing the component and group financial statements, (*b*) whether the audit of the component financial statements will be completed in time to meet the group reporting schedule, (*c*) differences in the auditing and other standards applied by the component auditor and those applied in the audit of the group financial statements, and (*d*) whether it is impracticable for the group engagement team to be involved in the work of the component auditor. (See paragraphs .22 and .A40 of AU-C section 600.)

[Issue Date: November 2012.]

[.05] Deleted

[Deleted, March 2013, due to the issuance of SAS No. 127, *Omnibus Statement on Auditing Standards—2013*. See section 8800.27, "Circumstances in Which Making Reference Is Inappropriate."]

.06 Governmental Financial Statements That Include a GAAP-Basis Component *Inquiry*—When a governmental university includes a nongovernmental foundation as a component unit in its financial statements, as required by the Governmental Accounting Standards Board (GASB) financial reporting framework (that is, a not-for-profit foundation that appropriately uses accounting principles generally accepted in the United States of America [GAAP] as promulgated by the Financial Accounting Standards Board [FASB]), may the auditor's report on the university's group financial statements make reference to the auditor of the foundation's financial statements when the group engagement team identifies the foundation as a component? *Reply*—Yes. In this situation, because the university (the primary government) is required by the GASB financial reporting framework to include the foundation as a component unit in the financial reporting entity (the group financial statements) and because GASB provides guidance on how to present component unit information that does not conform to GASB reporting standards, the financial statements of the foundation (a component) are deemed to be in accordance with the GASB financial reporting framework. It is important to note that reference to a component auditor in these circumstances is appropriate only when the provisions established by GASB that require inclusion of the component unit in the financial statements of the primary government have been followed (see section 8800.27).

[Issue Date: November 2012; Revised: March 2013.]

[.07] Deleted

[Deleted, March 2013, due to the issuance of SAS No. 127. See section 8800.27.]

.08 Component Audit Performed in Accordance With Government Auditing Standards

Inquiry—When a component auditor conducts an audit of a component's financial statements using *Government Auditing Standards* (GAS), and the group engagement team conducts the audit of the group financial statements using generally accepted auditing standards (GAAS), may the auditor's report on the group financial statements make reference to the component auditor?

Reply—Yes. Financial audits performed under the 2011 revision of GAS incorporate AICPA Statements on Auditing Standards by reference, as well as establish additional requirements. Further, the audit reports issued to meet GAS requirements often refer separately to GAAS, as well. Therefore, the audit of the component would be deemed to have been performed in accordance with GAAS, and the audit report on the group financial statements may make reference to the component auditor. Such reference is appropriate only when the component auditor follows the requirements established by GAAS when conducting the financial audit of the component under GAS. (See paragraphs .25 and .A54 of AU-C section 600.)

[Issue Date: November 2012.]

.09 Component Audit Performed by Other Engagement Teams of the Same Firm

Inquiry—Do the requirements of AU-C section 600 apply when a CPA firm uses auditors in different offices of the firm to perform various audit procedures related to the audit of a single entity's financial statements?

Reply—If the group engagement team identifies components in the financial statements of a single entity, it is a group audit, and AU-C section 600 applies. As defined in AU-C section 600, a *component auditor* may be part of the group engagement partner's firm, a network firm of the group engagement partner's firm, or another firm. (See paragraph .11 of AU-C section 600.)

[Issue Date: November 2012.]

.10 Terms of the Group Audit Engagement

Inquiry—What matters are required to be included in the terms of the group audit engagement?

Reply—The auditor of the group financial statements is required to agree upon the terms of the group audit engagement. In addition to the matters identified in AU-C section 210, *Terms of Engagement* (AICPA, *Professional Standards*), other matters may be included in the terms of a group audit, including whether reference will be made to the audit of a component auditor in the auditor's report on the group financial statements. The terms of the engagement may also include arrangements to facilitate (*a*) unrestricted communication between the group engagement team and component auditors to the extent permitted by law or regulation and (*b*) communication to the group engagement team of important communications between (i) component auditors, those charged with governance of the component, and component management and (ii) regulatory authorities and components related to financial reporting matters. (See paragraphs .17 and .A28 of AU-C section 600.)

[Issue Date: November 2012.]

.11 Equity Method Investment Component

Inquiry—If a company has an investment accounted for using the equity method, is the equity method investment considered a component for applying AU-C section 600?

Reply—Yes. An investment accounted for under the equity method constitutes a component for purposes of AU-C section 600. As such, the requirements of AU-C section 600 apply; however, paragraphs .50–.64 of AU-C section 600 only apply when the group engagement partner assumes responsibility for the work of a component auditor. (See paragraphs .11 and .A2 of AU-C section 600.)

[Issue Date: November 2012.]

.12 Criteria for Identifying Components

Inquiry—What criteria might the group engagement team use to identify components?

Reply—A *component* is defined as "[a]n entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements." The structure of a group and the nature of the financial information and the manner in which it is reported affect how the group engagement team identifies components. Components can be separate entities or may be identified on the basis of the group financial reporting system that may be (*a*) a parent, one or more subsidiaries, and so on; (*b*) a head office and one or more divisions or branches; or (*c*) both. (See paragraphs .11 and .A1 of AU-C section 600.)

In audits of state and local governments, a component may be a separate legal entity reported as a component unit or part of the governmental entity, such as a business activity, department, or program. (See paragraph .A5 of AU-C section 600.)

[Issue Date: November 2012.]

.13 Criteria for Identifying Significant Components

Inquiry—What criteria might the group engagement team use to identify significant components?

Reply—A *significant component* is a component of individual financial significance to the group or likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances. As the individual financial significance of a component increases relative to the group financial statements, the risks of material misstatement of the group financial statements (posed by the financial information pertaining to that component) typically increase. The group engagement team may apply a percentage to one or more chosen benchmarks to identify components that are of individual financial significance. Appropriate benchmarks might include group assets, liabilities, cash flows, revenues, expenditures, net income, or a combination of these. Components engaging in complex transactions, such as foreign currency transactions, derivatives, alternative investments, complex financing arrangements, and so on, may expose the group to a significant risk of material misstatement even though they are not otherwise of individual financial significance to the group. The group engagement team may consider such components as significant components due to these risks. (See paragraphs .11, .A6, and .A77 of AU-C section 600.)

In audits of governmental entities, appropriate quantitative benchmarks for identifying significant components might include net costs or total budget. Qualitative considerations may involve matters of heightened public sensitivity (for example, national security issues, donor-funded projects, or reporting of tax revenue).

[Issue Date: November 2012.]

.14 No Significant Components Are Identified

Inquiry—Do the requirements of AU-C section 600 apply when the group engagement team does not identify any significant components?

Reply—Yes. AU-C section 600 is applicable to audits of group financial statements, and group financial statements include financial information for more than one component, regardless of whether any component is identified as a significant component. When a group consists only of components not considered significant components, the group engagement partner can reasonably expect to obtain sufficient appropriate audit evidence (on which to base the group audit opinion) if the group engagement team will be able to (*a*) perform work on the financial information of some of these components and (*b*) use the work performed by component auditors on the financial information of other components to the extent necessary to obtain sufficient appropriate audit evidence. In addition, when no component is identified as significant, it is more likely that appropriate responses to assessed risks of material misstatement for some or all accounts or classes of transactions may be implemented at the group level without the involvement of component auditors. (See paragraphs .A19, .A65, and .A83 of AU-C section 600.)

[Issue Date: November 2012.]

.15 Restricted Access to Component Auditor Documentation

Inquiry—When a component auditor restricts the group engagement team's access to relevant documentation, will the auditor of the group financial statements be able to report on the group financial statements?

Reply—Yes. As long as the group engagement team is able to obtain sufficient appropriate audit evidence, the group engagement partner is able to report on the group financial statements. However, this is less likely as the significance of the component increases. (See paragraphs .16 and .A23 of AU-C section 600.)

[Issue Date: November 2012.]

.16 Responsibilities With Respect to Fraud in a Group Audit

Inquiry—Does AU-C section 600 change the auditor's responsibilities with respect to fraud in the audit of a group's financial statements?

Reply—No. The group engagement team is required to gain an understanding of the group and its environment and to identify and assess the risks of material misstatement of the group financial statements due to error or fraud. In addition, the group engagement team is required to design and implement appropriate responses to the assessed risks. (See paragraphs .20 and .A35 of AU-C section 600.)

[Issue Date: November 2012.]

.17 Inclusion of Component Auditor in Engagement Team Discussions

Inquiry—Is the engagement team required to include the component auditor in its discussions of the entity's susceptibility to material misstatements of the financial statements due to error or fraud?

Reply—No. Key members of the group engagement team are required to discuss the susceptibility of an entity to material misstatements of the financial statements due to error or fraud, specifically emphasizing the risks due to fraud. The group engagement partner may choose to include the component auditor in certain discussions, including those to discuss the susceptibility of the entity to material misstatements of the financial statements. (See paragraphs .20 and .A36 of AU-C section 600.)

[Issue Date: November 2012.]

.18 Determining Component Materiality

Inquiry—If the group engagement partner decides to make reference to a component auditor in the auditor's report on the group financial statements, does the group engagement team establish materiality for the component auditor to use in the separate audit of the component's financial statements?

Reply—No. Reference in the group auditor's report to the fact that part of the audit was conducted by a component auditor is intended to communicate that the group auditor is not assuming responsibility for the work of the component auditor. In that case, the component auditor is responsible for establishing materiality as part of performing the audit of the component's financial statements.

However, if the group engagement partner assumes responsibility for the work of a component auditor, the group engagement team is required to evaluate the appropriateness of materiality at the component level. In addition, the group engagement team is required to communicate the relevant component materiality to that component auditor. The component auditor uses component materiality to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate. (See paragraphs .31, .52–.53, .55, and .A73–.A74 of AU-C section 600.)

[Issue Date: November 2012.]

.19 Understanding of Component Auditor Whose Work Will Not Be Used

Inquiry—Is the group engagement team required to obtain an understanding of a component auditor for a component that is not a significant component if the group engagement team does not plan to use the work of the component auditor and plans only to perform analytical procedures at a group level?

Reply—No. It is not necessary to obtain an understanding of the auditors of those components for which the group auditor will not be using the work of the component auditor to provide audit evidence for the group audit. (See paragraphs .22, .29, and .A41 of AU-C section 600.)

[Issue Date: November 2012.]

.20 Involvement in the Work of a Component Auditor

Inquiry—When the group engagement partner decides to assume responsibility for the work of a component auditor, is the group engagement team required to be involved in the work of the component auditor?

Reply—Yes. The group engagement team is required to determine the type of work to be performed by the group engagement team (or a component auditor on behalf of the group engagement team) on the financial information of a component. The group engagement team is also required to determine the nature, timing, and extent of its involvement in the work of the component auditor. (See paragraph .51 of AU-C section 600.)

[Issue Date: November 2012.]

.21 Factors Affecting Involvement in the Work of a Component Auditor

Inquiry—What factors might affect the group engagement team's involvement in the work of a component auditor?

Reply—Factors that may affect the group engagement team's involvement in the work of a component auditor include (*a*) the significance of the component, (*b*) identified significant risks of material misstatement of the group financial statements, and (*c*) the group engagement team's understanding of the component auditor. (See paragraph .A84 of AU-C section 600.)

[Issue Date: November 2012.]

.22 Form of Communications With Component Auditors

Inquiry—When the group engagement partner decides to assume responsibility for the work of a component auditor, are all communications between the group engagement team and component auditor required to be in writing?

Reply—No. Communication between the group engagement team and a component auditor need not necessarily be in writing. For example, the group engagement team may visit the component auditor to discuss identified significant risks or review relevant parts of the component auditor's audit documentation. In all audits of group financial statements, however, communications between the group engagement team and component auditors about the group engagement team's requirements should be written. (See paragraphs .49, .59–.60, and .A87 of AU-C section 600.)

[Issue Date: November 2012.]

.23 Use of Component Materiality When the Component Is Not Reported On Separately

Inquiry—Is it necessary to use a component materiality lower than group materiality when the component will not be reported on separately, and the audit of the entire group is being performed by the group engagement team as one audit?

Reply—If the component is a significant component on which the group engagement team will be performing audit procedures, the group engagement team is required to determine component materiality. (See paragraph .31 of AU-C section 600.) To reduce the risk that uncorrected and undetected misstatements in each component's financial statements, when aggregated, do not exceed the materiality for the group's financial statements as a whole, component materiality should be less than the materiality for the group financial statements as a whole. In circumstances when appropriate responses to assessed risks of material misstatement for some or all accounts or classes of transactions may be implemented at the group level, for example when accounts receivable for the parent and subsidiaries use the same system and the consolidated accounts receivable are audited as one aggregated amount, there is no risk of aggregation error and, therefore, no need to allocate materiality to components.

[Issue Date: November 2012; Revised, February 2013.]

.24 Applicability of AU-C Section 600 When Only One Engagement Team Is Involved

Inquiry—Company X consolidates the operations of Entity A. The same group engagement team that audits Company X also audits Entity A. Because only one engagement team is involved, does AU-C section 600 apply? If so, what does AU-C section 600 require that is not already covered by other auditing standards?

Reply—AU-C section 600 applies to all audits of *group financial statements*, which are financial statements that contain more than one component. In the circumstances when the same engagement team audits all components of the group, the considerations addressed in AU-C section 600 that relate to component auditors are not relevant. However, considerations addressed in AU-C section 600, such as understanding the components; identifying components that are significant due to individual financial significance and the significant risk of material misstatement; determining component materiality; understanding the consolidation process; and addressing the risks, including aggregation risk, of material misstatement in the group financial statements; are relevant in all group audits.

[Issue Date: February 2013.]

.25 Applicability of AU-C Section 600 When Making Reference to the Audit of an Equity Method Investee

Inquiry—When the group engagement partner decides to make reference to the audit of the component auditor of an equity investee in the auditor's report on the group financial statements, is the group auditor still required to determine component materiality for those components for which reference to component auditors will be made?

Reply—Once the group engagement partner has decided to make reference to the audit of the component auditor, paragraph .26 of AU-C section 600 requires the group engagement team to obtain sufficient appropriate audit evidence with regard to the equity investee by

- performing the procedures required by AU-C section 600, except those required by paragraphs .50–.64.
- reading the equity investee's financial statements and component auditor's report thereon to identify significant findings and issues and, when considered necessary, communicating with the component auditor in this regard.

Therefore, when the group engagement partner has decided to make reference to the audit of a component auditor, the group engagement team is not required to determine component materiality for that component.

[Issue Date: February 2013.]

.26 Procedures Required When Making Reference to the Audit of an Equity Method Investee

Inquiry—The auditor of Company A has decided to make reference to the audit of the component auditor of an equity investee in the report on Company A's financial statements. In addition to obtaining and reading the equity investee's financial statements and component auditor's report thereon, what additional procedures may be necessary in order to determine that the equity investment has been properly recorded?

Reply—In determining that the equity investment has been properly recorded, the group engagement team may conclude that additional audit evidence is needed because of, for example, significant differences in fiscal year-ends, changes in ownership, or changes in conditions affecting the use of the equity method of accounting. Examples of procedures that the group engagement team may perform include, but are not limited to, reviewing information in the group's (investor's) files that relates to the equity investee, such as investee minutes, budgets, and cash flows information, and making inquiries of investor management about the equity investee's financial results.

[Issue Date: February 2013.]

.27 Circumstances in Which Making Reference Is Inappropriate

Inquiry—Are there any circumstances in which it would be inappropriate to make reference to the audit of a component auditor of an equity investee in the auditor's report on the group financial statements?

Reply—AU-C section 600 precludes the auditor of the group financial statements from making reference to the audit of the component auditor in the following circumstances:

- When the group engagement team has serious concerns about the component auditor's professional competency or independence. (In this circumstance, the group auditor is precluded from using the work of the component auditor at all.)

- The component auditor's report on the equity investee's financial statements is restricted regarding use.
- The audit of the component was not performed in accordance with the relevant requirements of GAAS or, if applicable, the standards promulgated by the Public Company Accounting Oversight Board (PCAOB).
- The financial statements of the component (that is, the equity investee) and group are prepared in accordance with different financial reporting frameworks, unless certain conditions are met.

Determining if the Audit of the Component Was Performed in Accordance With the Relevant Requirements of GAAS

When the component auditor has performed an audit of the component financial statements in accordance with auditing standards other than GAAS or the standards promulgated by the PCAOB, the group auditor is precluded from making reference, unless the group engagement partner has determined that the component auditor has performed an audit of the financial statements of the component in accordance with the relevant requirements of GAAS. Relevant requirements of GAAS in this context are those that pertain to planning and performing the audit of the component financial statements and do not include those related to the form of the auditor's report. Audits performed in accordance with International Standards on Auditing (ISAs) promulgated by the International Auditing and Assurance Standards Board (IAASB) are more likely to meet the relevant requirements of GAAS than audits performed in accordance with auditing standards promulgated by bodies other than the IAASB. The group engagement team may provide the component auditor with AU-C appendix B, *Substantive Differences Between the International Standards on Auditing and Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), that identifies substantive requirements of GAAS that are not requirements in ISAs.

The component auditor may perform additional procedures in order to meet the relevant requirements of GAAS. When the component auditor's report on the component's financial statements does not state that the audit of the component's financial statements was performed in accordance with GAAS or the standards promulgated by the PCAOB, and the group engagement partner has determined that the component auditor performed additional audit procedures in order to meet the relevant requirements of GAAS, the auditor's report on the group financial statements should clearly indicate

a. the set of auditing standards used by the component auditor and

b. that additional audit procedures were performed by the component auditor to meet the relevant requirements of GAAS.

Making Reference When Different Financial Reporting Frameworks Have Been Used

Conditions that, if met, permit the group auditor to make reference when the component financial statements are prepared in accordance with a different financial reporting framework than that used for the group financial statements are the following:

- The applicable financial reporting framework provides for the inclusion of component financial statements that are prepared in accordance with a different financial reporting framework, and as such, the component financial statements are deemed to be in accordance with the applicable financial reporting framework. For example, the financial reporting frameworks established by GASB and the Federal Accounting Standards Advisory Board have such provisions.
- The measurement, recognition, presentation, and disclosure criteria that are applicable to all material items in the component's financial statements under the financial reporting framework used by the component are similar to the criteria applicable to all material items in the group's financial statements under the financial reporting framework used by the group, and the group engagement team has obtained sufficient appropriate audit evidence for purposes of evaluating the appropriateness of the adjustments to convert the component's financial statements to the financial reporting framework used by the group without the need to assume responsibility for, and, thus, be involved in, the work of the component auditor.

When reference is made to a component auditor's report on financial statements prepared using a different financial reporting framework, the auditor's report on the group financial statements should disclose that the auditor of the group financial statements applied audit procedures on the conversion adjustments.

[Issue Date: February 2013.]

.28 Lack of Response From a Component Auditor

Inquiry—Paragraph .40 of AU-C section 600 requires the group engagement team to communicate to the component auditor and ask for his or her cooperation. Paragraph .41 of AU-C section 600 requires the group engagement team to ask the component auditor for certain information. If the component auditor does not respond to the group engagement team, is the auditor of the group financial statements precluded from making reference to the audit of a component auditor?

Reply—Lack of response from a component auditor to the communication and request for information from the group engagement team does not, in and of itself, preclude the group engagement partner from deciding to make reference to the audit of a component auditor. However, the group engagement team is required to obtain an understanding of the component auditor, in accordance with paragraph .22 of AU-C section 600, including

a. whether a component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.

b. a component auditor's professional competence.

c. whether the group engagement team will be able to obtain from a component auditor information affecting the consolidation process.

d. whether a component auditor operates in a regulatory environment that actively oversees auditors.

Obtaining this understanding may be more difficult when the component auditor does not respond to the communication from the group engagement team. When a component auditor does not meet the independence requirements that are relevant to the group audit, or the group engagement team has serious concerns about the other matters previously listed, the group engagement team should obtain sufficient appropriate audit evidence relating to the financial information of the component without making reference to the audit of that component auditor in the auditor's report on the group financial statements or otherwise using the work of that component auditor.

[Issue Date: February 2013.]

.29 Equity Investee's Financial Statements Reviewed, and Investment Is a Significant Component

Inquiry—Company X has an equity investment in Entity A that the group engagement team has identified as a significant component. If the management of Entity A has their financial statements reviewed but refuses to allow an audit or any other work to be performed on Entity A's financial statements, does a scope limitation exist?

Reply—Yes. If Entity A is a significant component, and no auditing procedures can be performed on Entity A's financial statements, a scope limitation exists, and the effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report* (AICPA, *Professional Standards*).

[Issue Date: February 2013.]

.30 Making Reference to Review Report

Inquiry—Is it ever appropriate to make reference to another CPA's review report in an auditor's report on group financial statements?

Reply—No, it is never appropriate to make reference to the review report on the component's financial statements in the auditor's report on group financial statements. AU-C section 600 only provides for making reference to the audit of a component auditor.

[Issue Date: February 2013.]

.31 Review of Component That Is Not Significant Performed by Another Practitioner

Inquiry—Company X has an equity investment in Entity A that is not considered a significant component. A review of the financial statements of Entity A has been performed by another practitioner. Can the group engagement team use the work of the practitioner as part of the audit evidence for the audit of the group financial statements?

Reply—Paragraphs .54–.55 of AU-C section 600 discuss certain procedures to be performed on a component when the component is not a significant component. In certain circumstances, a review of a component's financial statements may be sufficient audit evidence. Therefore, a group auditor may use the work of another practitioner if the review meets the needs of the group auditor. Although the group auditor may use the review as part of the auditor's evidence for the audit of the group financial statements, the group auditor is not permitted to make reference to the practitioner's review report.

[Issue Date: February 2013.]

.32 Issuance of Component Auditor's Report

Inquiry—Company X has an investment in Entity A accounted for under the equity method of accounting. Company X is audited by one firm, and a CPA from a different firm performs audit procedures at Entity A sufficient to provide the auditor of Company X with appropriate audit evidence relative to the equity investee's financial information. Is it necessary for the auditor of Company X to obtain an auditor's report on Entity A's financial statements from the component auditor?

Reply—Although an audit report is typically obtained when an independent CPA performs work for a group auditor of a different firm, there is no requirement that such report be obtained if the group auditor assumes responsibility for the component auditor's work. When the auditor of Company X will assume responsibility for, and, thus, be involved in, the work of a component auditor, a component auditor's communication with the group engagement team may take the form of a memorandum or report of work performed. Alternatively, the auditor of Company X may decide to review the component auditor's working papers documenting the audit procedures performed. However, in order for the auditor of Company X to make reference to the audit of the component auditor, it is necessary for the component auditor to issue an auditor's report on Entity A.

[Issue Date: February 2013.]

.33 Structure of Component Auditor Engagement

Inquiry—Company X has an investment in Entity A accounted for under the equity method of accounting. Entity A is not willing to pay for an audit of its financial statements. Would an agreed-upon procedures engagement performed by an independent CPA for Entity A be sufficient to provide the auditor of Company X with appropriate audit evidence relative to the investment in the equity investee?

Reply—The auditor of Company X is responsible for determining the nature and extent of the procedures necessary to provide the auditor of Company X with sufficient appropriate audit evidence relative to the investment in the equity investee. The nature and extent of the necessary procedures are based on the significance of the component to the group. A component auditor may perform specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements on behalf of the auditor of Company X. However, the structure of the engagement for the component auditor to perform the necessary procedures is not addressed by the standard.

[Issue Date: February 2013.]

.34 Subsequent Events Procedures Relating to a Component

Inquiry—Company X has an investment in Entity A that is accounted for by the equity method of accounting. Company X and Entity A are audited by different auditors. The audit of Entity A was completed before the audit of Company X began, and the auditor of Company X's financial statements has decided to make reference to the report of the auditor of Entity A. In such circumstances, who is responsible for performing auditing procedures relating to subsequent events at Entity A that may require adjustment to, or disclosure in, the group financial statements?

Reply—The auditor of the group financial statements is responsible for obtaining sufficient appropriate audit evidence that the group financial statements are free from material misstatement, regardless of whether reference is made to the audit of a component auditor. Paragraph .39 of AU-C section 600 states that for components that are audited, the group engagement team or component auditors should perform procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements and that may require adjustment to, or disclosure in, the group financial statements.

When the audit of the component is completed before the date of the auditor's report on the group financial statements, the group engagement team may communicate with the component auditor and ask the component auditor to perform procedures to identify subsequent events that would require adjustment to, or disclosure in, the group financial statements. Alternatively, the group engagement team may work with group management to obtain the necessary information and perform procedures themselves. Examples of procedures the group engagement team may perform include, but are not limited to, reviewing information in group management's files that relates to the component, such as component minutes, budgets, and cash flows information, and making inquiries of group management about the component's financial results.

If the group engagement team is unable to obtain sufficient appropriate audit evidence about subsequent events to make a determination about whether the group financial statements are materially misstated, then a scope limitation exists, and the effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of AU-C section 705.

[Issue Date: February 2013.]

.35 Component and Group Have Different Year-Ends

Inquiry—Company X has a component comprising an investment in Entity A accounted for by the equity method of accounting. Entity A is audited by a component auditor. Entity A has a different year-end than Company X. The auditor of the group financial statements has decided to make reference to the audit of the component auditor. What procedures, if any, would be appropriate for the group engagement team perform as a result of the difference in year-ends?

Reply—FASB *Accounting Standards Codification* (ASC) 323-10-35-6 states that "[i]f financial statements of an investee are not sufficiently timely for an investor to apply the equity method currently, the investor ordinarily shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period." When a time lag in reporting between the date of the financial statements of the group and that of the component exists, appropriate procedures performed by the group engagement team include consideration of whether the time lag is consistent with the prior period in comparative statements and, as discussed in section 8800.15, "Restricted Access to Component Auditor Documentation," whether a significant transaction occurred during the time lag that would require adjustment to, or disclosure in, the group financial statements. The group engagement team may also perform auditing procedures on the information from the period audited by the component auditor to Company X's year-end (stub period). If the group engagement team is unable to obtain sufficient appropriate audit evidence about the stub period information, a scope limitation exists, and the effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of AU-C section 705. If a change in stub period occurs that has a material effect on the group's financial statements, the auditor should consider the consistency of the financial statements for the periods presented, in accordance with AU-C section 708, *Consistency of Financial Statements* (AICPA, *Professional Standards*), because of the change in reporting period.

[Issue Date: February 2013.]

.36 Investments Held in a Financial Institution Presented at Cost or Fair Value

Inquiry—Paragraph .11 of AU-C section 600 defines a component as "[a]n entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements." Is an investment in a certificate of deposit or other types of cash investments held by a financial institution (for example, an overnight repurchase agreement) deemed a component for purposes of AU-C section 600?

Reply—No. A certificate of deposit or other cash investments held by a financial institution or bank do not constitute components.

[Issue Date: February 2013.]

.37 Employee Benefit Plan Using Investee Results to Calculate Fair Value

Inquiry—Do the investments in an employee benefit plan that rely on the investee results to calculate fair value constitute components under AU-C section 600?

Reply—No. Generally, the investments held by an employee benefit plan are required to be accounted for at fair value, with limited exceptions, and do not constitute a *component*, as defined under AU-C section 600; therefore, AU-C section 600 would not apply.

[Issue Date: February 2013.]

.38 Using Net Asset Value to Calculate Fair Value

Inquiry—Paragraphs 59–62 of FASB ASC 820-10-35 permit a reporting entity to estimate the fair value of an investment using net asset value (NAV) per share of the investment (or its equivalent) if NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies*, as of the reporting entity's measurement date. If an entity uses the NAV of an investment as a practical expedient to estimate the fair value of that investment, is that investment considered a component under AU-C section 600?

Reply—No. Paragraph .A2 of AU-C section 600 states that an investment accounted for under the equity method constitutes a component for purposes of AU-C section 600. AU-C section 600 does not specifically identify what other, if any, types of investments may be considered components under the definition in that section.

When an entity elects to use NAV as a practical expedient, paragraph .04 of AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items* (AICPA, *Professional Standards*), generally applies because it addresses situations when investments in securities are valued based on an investee's financial results, excluding investments accounted for using the equity method of accounting.

Paragraph .04 of AU-C section 501 states that when investments in securities are valued based on an investee's financial results, excluding investments accounted for using the equity method of accounting, the auditor should obtain sufficient appropriate audit evidence in support of the investee's financial results, as follows:

a. Obtain and read available financial statements of the investee and the accompanying audit report, if any, including determining whether the report of the other auditor is satisfactory for this purpose.

b. If the investee's financial statements are not audited or if the audit report on such financial statements is not satisfactory to the auditor, apply or request that the investor entity arrange with the investee to have another auditor apply appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor entity.

c. If the carrying amount of the investment reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, obtain sufficient appropriate audit evidence in support of such amounts.

d. If the difference between the financial statement period of the entity and investee has or could have a material effect on the entity's financial statements, determine whether the entity's management has properly considered the lack of comparability, and determine the effect, if any, on the auditor's report.

[Issue Date: February 2013.]

.39 Disaggregation of Account Balances or Classes of Transactions

Inquiry—Company X consolidates the operations of Entity A. The same group engagement team audits Company X and the operations of Entity A; no other auditors or engagement teams are involved. Are there any requirements in AU-C section 600 to disaggregate account balances or classes of transactions for purposes of auditing the consolidated financial statements of Company X? For example, is the auditor required to disaggregate accounts receivable for purposes of confirmation procedures, or can the consolidated group of accounts be treated as one population?

Reply—AU-C section 600 does not require the auditor to disaggregate account balances or classes of transactions. The group auditor should design an audit plan that is responsive to the risks of material misstatements to the consolidated financial statements. The less similar the risks of material misstatement at the group and component level, the less appropriate it may be to perform audit procedures for some or all accounts or classes of transactions at the group level. Additionally, the more complex the group (for example, decentralized systems, fewer groupwide controls, differing jurisdictions, or diverse product lines), the less likely that testing in the aggregate will sufficiently and appropriately address the risks of material misstatement.

[Issue Date: February 2013.]

.40 Variable Interest Entities (VIEs) as a Component

Inquiry—Company X consolidates the financial information of Entity A, a variable interest entity of which Company X is the primary beneficiary. Is Entity A considered a component for purposes of AU-C section 600?

Reply—Yes. Paragraph .11 of AU-C 600 defines a component as "[a]n entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements." Because Entity A's financial information is required to be consolidated into Company X's financial statements, Entity A constitutes a component for purposes of AU-C section 600. As such, the requirements of AU-C section 600 apply.

[Issue Date: March 2013.]

.41 Component Using a Different Basis of Accounting Than the Group

Inquiry—A component whose financial information is required to be consolidated into group financial statements maintains its financial information on the tax basis of accounting. The group financial statements are prepared using GAAP. What is the group auditor's responsibility regarding the consolidation of the component's financial information into the group financial statements?

Reply—When a component's financial information is prepared on the tax basis of accounting, and the group financial statements are prepared using GAAP, the auditor is required by paragraph .36 of AU-C section 600 to evaluate whether the financial information of the component has been appropriately adjusted. Appropriate adjustments are adjustments that convert the tax basis of information to GAAP basis. An example of this is converting depreciation under the method used for tax purposes by the component to depreciation calculated using the method used for the group financial statements.

[Issue Date: March 2013.]

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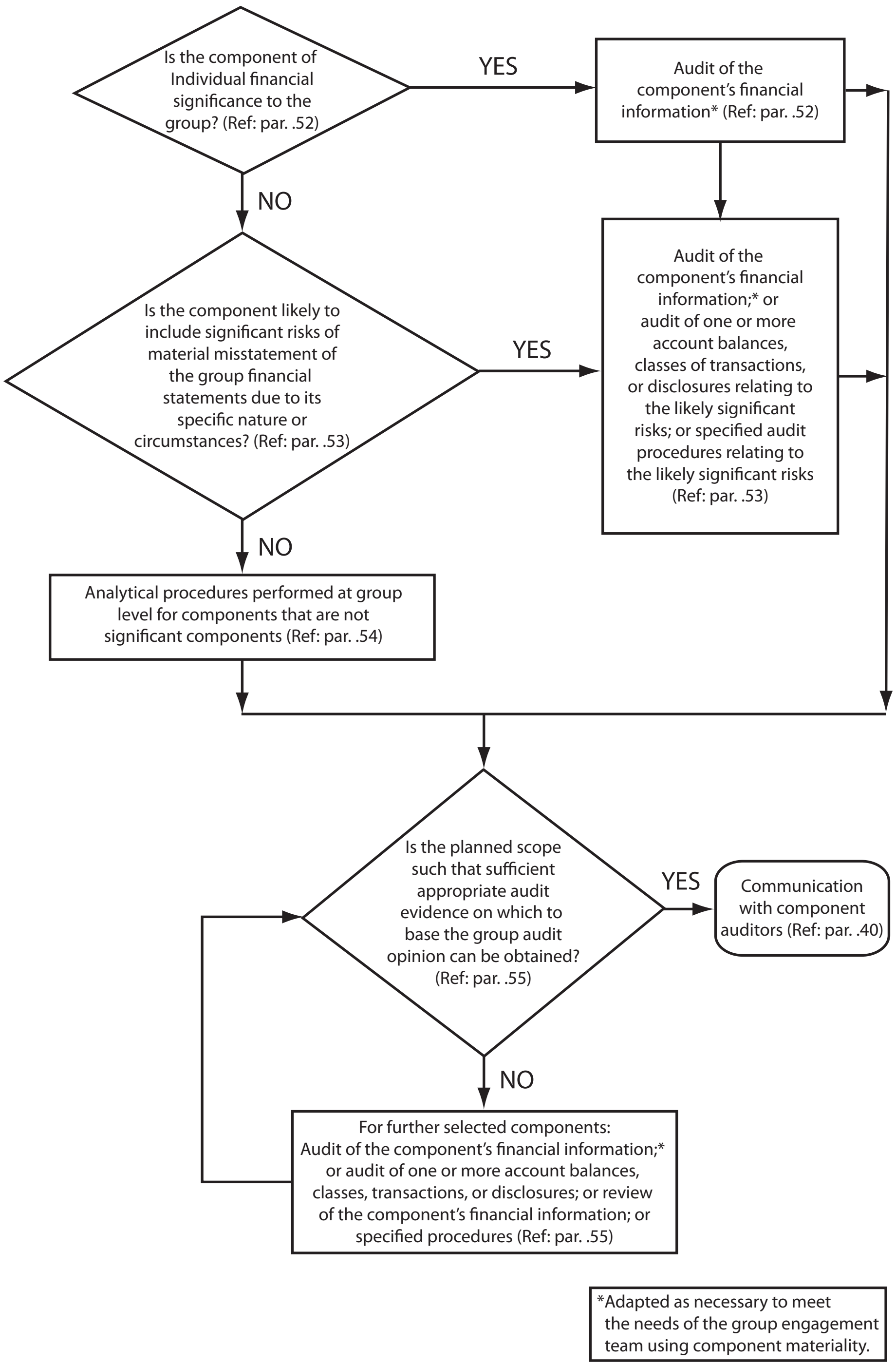
Appendix B — Decision-Making Flowchart

AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), establishes specific requirements related to components that the group engagement team identifies as significant and those that are not significant (discussed in paragraphs .61–.63 of this alert). The following flowchart, found in paragraph .A79 of AU-C section 600, depicts how the significance of the component affects the group engagement team's determination of the type of work to be performed on the financial information of the component.



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Appendix C — Examples

Example 1 — Not-for-Profit University With Consolidated Financial Statements, Two Auditors, and Different Reporting Periods

Facts

A not-for-profit university (University) prepares consolidated financial statements (in accordance with the requirements in Financial Accounting Standards Board *Accounting Standards Codification* 958-810) that include consolidated financial information for the University, its legally separate not-for-profit foundation (Foundation), and its legally separate but related alumni association (Association). The Foundation and Association provide services that directly benefit the university or its students, alumni, or faculty. To prepare the consolidated financial statements, the University uses the information provided in the audited financial statements of the separate entities.

Both the University and the Foundation are required to have an annual audit of their financial statements by state statute and by their respective corporate bylaws. After a competitive selection process, CPA Firm A was appointed to a five-year contract by the joint university-foundation audit selection committee two years ago to audit both the University and the Foundation. For the current year, CPA Firm A will audit the June 30, 2013, financial information of the University and the Foundation, as well as the consolidated financial statements as of June 30, 2013.

CPA Firm B was selected by the Association's board of directors as the independent auditor years ago upon creation of the Association. An annual audit of the Association's financial statements is required by the Association's corporate bylaws. The Association does not have an audit committee because the board of directors feels it provides adequate oversight of financial reporting and the auditor selection process. Audited financial information for the year ended December 31, 2012, will be adjusted through June 30, 2013, and included in the combined financial statements as of June 30, 2013. Historically, CPA Firm A has used the Association's audited financial statements as audit evidence for the consolidated financial statements and has made reference to the work of CPA Firm B in the auditor's report on the consolidated financial statements.

In addition to education and the related administrative support activities, significant business activities of the University include parking, housing, a book store, and food service operations. All of these services except parking are performed under contracts with various private-sector entities. Information related to the contract activities is as follows:

- *Housing.* The University owns all dorms, equipment, and furnishings, and the contractor provides cleaning and routine maintenance services for all facilities under contract. In addition, the contractor processes student housing requests and assignments (applications, selection and assignment of students, executing student housing contracts, pre- and post-inspections of student rooms) and sends an electronic file to the University with all student room and billing information. The University bills each student for room and board on the individual student's tuition statement at the beginning of each term. Each month, the University pays the contractor a set fee for each application processed and a set fee per dorm resident for operating and maintaining the dorms. Amounts remitted to the contractor are based on student population information maintained by the University.
- *Book store.* The contractor provides a full turn-key operation, and in return the contractor pays the University a monthly commission based on the previous month's sales. The contractor provides a monthly sales and returns summary report to the University's business services department (Business Services) that details the calculation of the amount remitted. Business Services records commission revenue upon receipt of the contractor's payment through the University's financial management system. Under the terms of the contract, the University has the authority to review the contractor's operations and sales records at any point with proper notice to the contractor. The contract requires the contractor to provide the University with an annual summary of monthly sales and returns by type within 30 days of the University's fiscal year end. In addition, the contract requires that the information be subject to certain agreed-upon procedures that are performed by and

reported on by the contractor's auditor (CPA Firm C). Business Services recalculates the commission revenue using this information and compares it to the amounts reported and remitted for the year.

- *Food service.* The University owns and maintains all food service-related facilities, equipment, and furnishings with routine maintenance provided and arranged by the buildings and grounds department through the University work order system at the request of the contractor. All purchases and sales are processed through various automated and integrated systems of the University by the contractor. The contractor uses the University's integrated purchase order system for ordering food and supplies and a point-of-sale register system that is integrated with the University's cash receipts system. A perpetual inventory system is owned and operated by the contractor, and a quarterly inventory is conducted by the contractor under the supervision and direction of Business Services. Under terms of the contract, the University has the authority to review any of the contractor's operations at any point in time. Employees working in the food service operation are hired, scheduled, and paid by the contractor. Each month the University pays the contractor an agreed-upon administrative charge, which is calculated by Business Services using sales and purchases information generated by the University's financial management system.

Activities conducted by the Foundation include fund raising, community awareness, and advocacy all for the exclusive benefit of the Foundation and the University. In addition, the Foundation provides portfolio management services for all of the Foundation and University board and donor designated endowment funds. The Foundation charges a management fee for these services that is deducted from the earnings recorded by the endowment funds. The University provides a contractually agreed-upon contribution each year to help defray the Foundation's operating costs. All activities are accounted for and recorded by the Foundation.

The Association is housed in a separate building on campus that is owned and maintained by the University. The University provides a contractually agreed-upon contribution each year to help defray the Association's operating costs. All activities are accounted for and recorded by the Association. Business activities of the Association include sponsoring alumni social, educational, and informational events; conducting fundraising activities for the benefit of the Association; and communicating on a regular basis with alumni about other alumni-related activities.

Commentary

This is a *group audit* as defined in AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), because the consolidated financial statements represent group financial statements; that is, they include financial information for more than one component (financial information for the University, the Foundation, and the Association).

The components in this example could be identified by the group engagement team as the three separate legal entities for which financial information is included in the consolidated financial statements: the University, Foundation, and Association. It is likely not efficient to identify business activities as components in this example because the group financial statements are prepared using the entity-level audited financial statements (financial information) rather than financial information at the business activity level (see paragraph .A1 of AU-C section 600). The housing, book store, and food service business activities would likely be considered in the risk assessment process related to the audit of the financial statements of the University by CPA Firm A. Business activities of the Association would also likely be considered in the risk assessment process related to the audits of those individual financial statements by CPA Firm B.

Additionally, more than one auditor is performing work on the financial information that is included in the group financial statements (consolidated financial statements). In this example, CPA Firm A is responsible for the consolidated financial statements (that is, the group audit engagement) and would therefore be the auditor of the group financial statements (see paragraph .11 of AU-C section 600). As the auditor of the Association's financial statements, CPA Firm B would be a component auditor. In addition, in the group audit of the consolidated financial statements of the University and the Foundation, the staff members of CPA Firm A assigned to the audit of the Foundation's financial statements would each meet the definition of a component auditor for purposes of that audit (see paragraph .A11 of AU-C section 600). The group engagement partner would decide whether to make reference to the audit report of CPA Firm B in the audit report on the group financial statements (consolidated financial statements).

CPA Firm C would not be considered a component auditor because the financial information included in the group financial statements (consolidated financial statements) is aggregated at an entity level rather than a business activity level. Additionally, the financial information on which CPA Firm C performs the agreed-upon procedures is not used to record the financial information related to the book store (business activity). Business Services simply uses the information to affirm the amount of commissions received for the fiscal year.

Example 2 — Private Sector Entity With Multiple Locations and Business Activities, Same Auditor Using Different Firm Offices

Facts

A multi-office CPA firm provides audit services for a medium-sized privately held company that has significant operations in three states. The company has a central distribution center located in Arkansas and a regional sales office located in Georgia. Administrative offices, as well as another regional sales office, are located at the company's corporate headquarters in California.

The company reports operating, performance, and selected financial information at a division level for the distribution center and the two sales offices. All other operating and financial information is aggregated and reported at a corporate-wide level. Divisional and corporate level information for the company is as follows:

- *Regional sales offices.* Each regional sales office has a domestic and an international division. Domestic sales account for approximately 80 percent of the company's total annual sales. Various personnel at each regional sales office account for all customer and sales order transactions using the company's integrated operations management system. No shipping, billing, or collection information is processed at the regional sales offices. Executive leadership at the administrative office develops the pricing structure and schedule used by the regional sales offices in soliciting orders. In prior years, the auditor identified significant risks at both offices due to missing or ineffective controls, including little oversight and training.

- *Central distribution center.* The distribution center has three divisions: purchasing, receiving, and shipping. Shipments are made using sales order information entered in the integrated operations management system by personnel at the regional sales offices. A perpetual inventory system is maintained by the receiving division, but it is not integrated with the company's financial accounting system. Various personnel in the three divisions at the central distribution center account for all transactions occurring at the distribution center using the company's integrated operations management system. The company does not enter into long term purchase commitments.

  Certain aspects of the company's integrated operations management system interface with the financial accounting system. Purchases are integrated in the company's financial accounting system when the goods are noted as being received in the integrated operations management system by personnel in the receiving division. Customer information entered at the regional sales offices and shipping information entered by the shipping division at the central distribution center are integrated with the customer billing subsystem that is integrated with the financial accounting system. All customer billing is done by the accounting department (located at the company's headquarters) using the customer billing subsystem. Each month the receiving division provides ending inventory information to the accounting department, at which point it is recorded as one amount in the company's financial accounting system. No significant risks related to the distribution center have been identified by the auditor in prior years.

- *Administration.* All executive, finance, accounting, and financial reporting and human resources functions are conducted at the corporate headquarters in California. In addition to developing the pricing structure and schedule, the executive office maintains price master file information that integrates with shipping information during the customer billing process. The company uses a lock box system for the receipt and processing of all customer receipts (electronic funds transfers or checks), which are downloaded daily by the accounting department into the company's financial accounting system.

The engagement partner and engagement team work in the CPA firm's California office; accordingly, the CPA firm's California office will coordinate the audit of, and report on, the financial statements for the year ended December 31, 2012. As in prior year audits, the audit strategy will be developed by the engagement team and will include using personnel in the CPA firm's Georgia and Arkansas offices to perform certain procedures at the company's Georgia regional sales office and central distribution center, respectively. The engagement team will develop the audit plan and coordinate and oversee the work performed by the Georgia and Arkansas offices of the CPA firm.

Personnel in the CPA firm's Arkansas office will be utilized by the engagement team to observe the annual inventory and perform test counts. In addition, the Arkansas office personnel will be utilized to perform risk assessment procedures related to all operations and to perform control tests for certain processes related to the receiving division of the central distribution center. The engagement team will utilize personnel in the CPA firm's Georgia office to perform risk assessment procedures and further audit procedures (tests of controls and substantive tests of details), all of which will be developed by the engagement team. Members of the engagement team will perform risk assessment procedures and further audit procedures (tests of controls and substantive tests of details) for the California regional sales office.

Commentary

This is a *group audit* as defined in AU-C section 600 because there is more than one component (based on business activities defined as either geographic locations or operating activities or divisions). This example is depicting the identification of components by function or process.

The accounting and financial reporting function at the administrative office and the receiving division at the central distribution center are components because they provide financial information that is required to be included in the group financial statements by the financial reporting framework. The receiving division provides purchasing and ending inventory information that is used to record inventory, accounts payable, and cost of goods sold, all of which are required under generally accepted accounting principles. Therefore, the receiving division is a business activity meeting the definition of a component under AU-C section 600. All other information required to be included in the financial statements is prepared by the accounting and financial reporting function, which constitutes a business activity meeting the definition of a component under AU-C section 600.

The regional sales offices provide order information to the shipping division at the central distribution center and, therefore, do not provide any information that is required to be included in the financial statements by the financial reporting framework. For that reason, they would not be considered a business activity that meets the definition of a *component*.

Similarly, the purchasing and shipping divisions (discussed in the following paragraph) at the central distribution center do not provide any information that is required to be included in the financial statements. The purchasing division provides information to the receiving division related only to items ordered. Although purchase orders represent a commitment, they do not result in information that is included in the financial statements; therefore, the purchasing division does not meet the definition of a *business activity* that would be considered a component under AU-C section 600.

Sales and accounts receivable information is required to be included in the financial statements, but that information is prepared by the accounting department. This information is developed from pricing information maintained by the executive offices and shipping information maintained by the shipping division. Therefore, neither the executive office nor shipping division meets the definition of a *business activity* that would be considered a component under AU-C section 600. However, the group engagement team would likely consider these business activities using a "top down" risk assessment process.

A component auditor may be part of the group engagement partner's firm; the CPA firm's Arkansas office is a component auditor because it is performing work on financial information of a component (that is, inventory observation, risk assessment procedures for the central distribution center, and tests of controls over certain processes at the receiving division of the central distribution) that is included in the group financial statements (company financial statements). AU-C section 600 requires the group engagement team to determine the type of work to be performed by component auditors on its behalf and the nature, timing, and extent of its involvement in the work of component auditors. The engagement team will meet this requirement by, as noted in the facts, developing the audit plan and coordinating and overseeing the work performed by the Arkansas office of the CPA firm. The Georgia office does not meet the definition of a *component auditor* because it is not performing work on the financial information of a component; however, because the engagement team is requesting that the work be performed on its behalf, it is appropriate for the engagement team to develop the audit plan and coordinate and oversee the work performed by the Georgia office of the CPA firm.

Example 3 — Private Sector Entity With One Location and One Auditor, Using Network Firm

Facts

This example uses most of the same facts as those in example 2 of this appendix, except as follows:

- The CPA firm has only one office, and it is located in California.
- The CPA firm will be using two network firms, one in Arkansas (Arkansas Firm) and one in Georgia (Georgia Firm), to assist in the financial statements audits.

Commentary

The fact that the other auditors assisting the engagement team are not from the same firm but from network firms does not change the engagement team's responsibilities or required procedures from those in the previous example. Arkansas Firm is a component auditor for the same reasons the Arkansas Office was in the previous example. Because the components on which Arkansas Firm will be performing audit procedures do not issue separate financial statements on which Arkansas Firm will be issuing an auditor's report, CPA Firm cannot make reference to the report of Arkansas Firm.

The Georgia office does not meet the definition of a *component auditor* because it is not performing work on the financial information of a component; however, because the engagement team is requesting that the work be performed on its behalf, it is appropriate for the engagement team to develop the audit plan and coordinate and oversee the work performed by the Georgia office of the CPA firm.

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Appendix D — Applying Group Materiality to Components

Example 1 — Not-for-Profit Organization

CPA Firm will be auditing a nonprofit entity consisting of a national office and separate chapters located across the country. The following chart provides the chapter and consolidated balance sheets of the entity. This example assumes the group engagement team considered group materiality of $728,000 and group performance materiality of $546,000, as well as the following factors, when identifying the following significant components:

- Components that are separate legal entities and significant based on their individual financial significance to the group, for example, in the following table, National/Corporate, the New York chapter, and the Chicago chapter (indicated by double border)
- Components that are business activities and significant based on their individual financial significance to the group, for example, in the following table, the shared service centers (indicated by double border; accounts highlighted in gray are those whose transactions are processed by the shared service centers)
- Components that are significant components based on the existence of significant risks, for example, in the following table, investments for the Los Angeles chapter and other chapters (indicated by a single border)

The auditor of the group financial statements will reference the work of the component auditors auditing the Chicago chapter. The group engagement team will perform, or ask component auditors to perform on its behalf, procedures on selected financial information, including contributions receivable, investments, and accrued payroll (highlighted in gray), for the National/Corporate, shared service centers, New York chapter, Los Angeles chapter, and other chapters. No reference will be made to the component auditors performing these procedures.

	National/ Corporate	*Shared Service Centers* *Contributions, Investments & Payroll*	*New York Chapter*	*Chicago Chapter*	*Los Angeles Chapter*	*Other Chapters*	*Total*
Assets:							
Cash and cash equivalents	$662,958		$1,988,873	$1,104,929	$(65,953)	$728,911	$4,419,717
Contributions receivable	245,000	845,724	490,826	272,681	2,915	79,302	1,090,724
Investments	3,232,987	18,320,258	9,698,960	5,388,311	1,730,256	1,502,731	21,553,245
Beneficial Interests in trusts	5,305,320		—	—	—	—	5,305,320
Land, building, and equipment, net	462,224		1,386,671	770,373	320,150	142,074	3,081,491
Other assets	142,438		427,313	237,396	60,214	82,224	949,585
Total assets	10,050,926		13,992,643	7,773,691	2,047,582	2,535,241	36,400,082
Liabilities:							
Accounts payable	$195,812		$587,436	$326,354	$64,259	$131,553	$1,305,414
Accrued payroll	349,414	1,980,014	1,048,243	582,357	164,329	185,085	2,329,428
Other accrued expenses	52,237		156,712	87,062	31,947	20,290	348,249
Deferred revenue	50,275		150,825	83,792	270	50,005	335,166
Other liabilities	561		1,683	935	—	561	3,739
Total liabilities	648,299		1,944,898	1,080,499	260,805	387,494	4,321,996
Net Assets	9,402,626		12,047,745	6,693,192	1,786,777	2,147,747	32,078,086
Total Liabilities and Net Assets	$10,050,926		$13,992,643	$7,773,691	$2,047,582	$2,535,241	$36,400,082

Applying Component Materiality

Some of the key considerations for the group when applying component materiality are as follows:

1. The group auditor will be referencing the work of the component auditor of the Chicago chapter. Therefore, there is no need to communicate component materiality to that auditor. However, the group auditor is required to consider all components when determining component materiality.

2. The group auditor intends to assume responsibility for the work of component auditors on the Los Angeles chapter and other chapters. Therefore, the group auditor is required to communicate the materiality to be used in performing procedures on the highlighted accounts. It is likely in this case, because the balances are small compared to the financial statement total amounts, that the group auditor will actually determine the scope of procedures to be performed based on the remaining available materiality.

3. The component auditors to be referred to will be auditing approximately 21 percent of total assets and 21 percent of net assets. As such, the group auditor may consider one-fifth of the $728,000 in group materiality to be applied to those components. The group auditor might estimate that component materiality of 75 percent to 85 percent of group materiality might be appropriate for the remaining components.

4. The group auditor may also consider, due to specific risks in the remaining components, to use a lesser level of materiality.

5. The combined component materiality may exceed group materiality as long as each component materiality is less than group materiality.

6. In addition, the group auditor is required to determine performance materiality for the remaining components.

Example 2 — Multinational Manufacturing Company

This example is derived from the December 2008 issue of the *Journal of Accountancy* article "Component Materiality for Group Audits."[1] The example describes a large manufacturing company with 5 significant components operating in various jurisdictions around the world. The entity has the following revenue information for the significant components, which represents 90 percent of total revenue.

Component	Revenues
1	60,000,000
2	50,000,000
3	40,000,000
4	30,000,000
5	20,000,000
Total revenue	200,000,000

Using a benchmark of revenue, the group auditor has determined group materiality to be $1,000,000. Component materiality may be allocated as follows.

This table shows the proportionate allocation approach based on relative sales values.

Component	Revenue	Component materiality
1	60,000,000	300,000
2	50,000,000	250,000
3	40,000,000	200,000
4	30,000,000	150,000
5	20,000,000	100,000
Total revenue	200,000,000	1,000,000

Alternatively, component materiality could be allocated to each component at an amount slightly below group materiality.

Component	Revenue	Component materiality
1	60,000,000	900,000
2	50,000,000	900,000
3	40,000,000	900,000
4	30,000,000	900,000
5	20,000,000	900,000
Total revenue	200,000,000	4,500,000

Although both methods are permitted by AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (AICPA, *Professional Standards*), the first is likely to be

[1] The article and complete example can be found at www.journalofaccountancy.com/Issues/2008/Dec/ComponentMaterialityforGroupAudits.htm.

overly conservative and lead to too much audit work, and the second is likely to be too aggressive and increase the detection risk of a misstatement at the group level to an undesirably high level.

The Probabilistic Model

This method as described in the article uses a probabilistic model to increase the group materiality to a maximum aggregate group materiality based on the number of components. In this case, the factor used is 2.5 times. As such, the aggregate of component materiality is targeted at $2,500,000.

Once the aggregate is determined, there are two approaches to apply to the components. One is the straight relative revenue model as seen in the preceding table. The second is a weighted average method, using a sum of the squares approach. The following table illustrates the two approaches.

Component	Revenue	Proportionate Allocation	Weighted Average Allocation
1	60,000,000	750,000	622,750
2	50,000,000	625,000	568,500
3	40,000,000	500,000	508,600
4	30,000,000	375,000	440,600
5	20,000,000	250,000	359,550
Total revenue	200,000,000	2,500,000	2,500,000

The group auditor can then review this table and determine based on risk factors in specific components the final allocation of group materiality. This might look as follows.

Component	Revenue	Proportionate Allocation	Weighted Average Allocation	Group Engagement Team Determination
1	60,000,000	750,000	622,750	690,000
2	50,000,000	625,000	568,500	590,000
3	40,000,000	500,000	508,600	500,000
4	30,000,000	375,000	440,600	420,000
5	20,000,000	250,000	359,550	300,000
Total revenue	200,000,000	2,500,000	2,500,000	2,500,000

In all cases, the group auditor is required to consider specific risks and design an audit strategy that will effectively lower that risk to an acceptable level.

One should note that the preceding methodologies are neutral with respect to the role of component auditors. In situations in which the group auditor will be making reference to the work of the component auditor, it is still necessary to consider materiality even though it is not required to be communicated. If the group auditor can determine the materiality used by the component auditor, that may enable the group auditor to apply more materiality to other components.

For instance, if component five in the preceding example is to be audited by a component auditor and the group auditor is making reference, and if the component auditor intends to use $100,000 as materiality for that component, the group auditor has more aggregate materiality to apply to any or all of the other four components.

If the group auditor intends to take responsibility for the work of the component auditors and the required procedures are less than an audit adapted as necessary (that is, a review or procedures on certain accounts), the group auditor may want to reduce the materiality for those components and once again apply more component materiality to other components while retaining the same total aggregate component materiality.

Successfully applying component materiality can have many permutations and does not lend itself well to a formulaic approach. Proper planning and judgment are necessary in order to have an efficient and effective group audit.

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Appendix E — Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities.	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things.	www.aicpa.org/FRC
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations.	www.aicpa.org/RESEARCH/STANDARDS/COMPILATIONREVIEW/ARSC/Pages/ARSC.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies.	www.economy.com
The Federal Reserve Board	Source of key interest rates.	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities.	www.fasb.org
Governmental Accountability Office (GAO)	*Government Auditing Standards* and other GAO activities.	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities.	www.gasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards.	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing.	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena.	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting.	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters.	www.pcaob.org

(continued)

Website Name	*Content*	*Website*
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database.	www.sec.gov
USA.gov	Portal through which all government agencies can be accessed.	www.usa.gov

[*The next page is 8071.*]

AAM Section 8015

Compilation and Review Developments—2013/14

STRENGTHENING ENGAGEMENT QUALITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This 2013/14 edition of the AICPA Alert *Compilation and Review Developments* replaces the AICPA Alert *Compilation and Review Developments—2012/13*.

This Compilation and Review Alert (alert) is intended to provide accountants with an update on recent practice issues and professional standards that affect compilation and review engagements. This alert also can be used by an entity's internal management to address areas of concern.

This publication is an other compilation and review publication, as defined in paragraph .20 of AR section 60, *Framework for Performing and Reporting on Compilation and Review Engagements* (AICPA, *Professional Standards*). Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply the Statements on Standards for Accounting and Review Services.

If applying the guidance included in an other compilation and review publication, the accountant should, using professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the engagement as appropriate. The guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior committee of the AICPA.

Recognition

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The AICPA gratefully acknowledges those members of the Accounting and Review Services Committee and the AICPA Technical Issues Committee who helped identify the interest areas for inclusion in this alert.

Feedback

The alert *Compilation and Review Developments* is published annually. As you encounter issues that you believe warrant discussion in next year's alert, please feel free to share them with us. Any other comments you have about the alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Compilation and Review Alert (alert) helps practitioners plan and perform compilation and review engagements and can also be used by an entity's management to plan and prepare in advance of the engagement. This alert discusses recent Statements on Standards for Accounting and Review Services (SSARSs) developments, addresses current and emerging practice issues, and provides valuable information regarding accounting and reporting developments. You should refer to the full text of accounting and compilation and review pronouncements as well as the full text of any rules or publications that are discussed in this alert.

Economic Developments

The Current Economy

.02 In performing a compilation or review engagement, accountants should possess an understanding of the industry in which the client operates.[1] This understanding may be affected by general economic conditions. For example, interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions, are likely to have an effect on an entity's industry, its business and, ultimately, its financial statements. Considering the effects of these external forces may help the accountant better understand the client's industry and the client's business. For review engagements, these considerations may also help the accountant determine the specific nature, timing, and extent of review procedures to be performed.

.03 During 2012 and into 2013, the U.S. economy has continued to recover. The S&P 500 and the Dow Jones Industrial Average have reached all-time highs during 2013. The Chicago Board Options Exchange Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock option prices and is considered by many to indicate investor sentiment, market volatility, and the best gauge of fear in the market. The VIX has continued to show a steady decline during 2013. As of November 2013, the 52-week high and low are 23.23 and 11.05, respectively. The volatility shows there is still some uncertainty; however, the continued downward trend shows that investors believe the economy and market are improving.

Key Economic Indicators

.04 The following key economic indicators reaffirm the recovery of the economy during 2013: gross domestic product (GDP), unemployment, and the federal fund rate. The GDP measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.5 percent in the second quarter of 2013, based on the advance estimate (third estimate). Real GDP increased at an annual rate of 1.1 percent in the first quarter of 2013. The increase in real GDP in the second quarter primarily reflected positive contributions from personal consumption expenditures, exports, nonresidential fixed investment, private inventory investment, and residential fixed investment that were partly offset by a negative contribution from federal government spending. Imports, which are a subtraction in the calculation of GDP, increased.

.05 From September 2012 to September 2013, the unemployment rate fluctuated between 7.8 percent and 7.2 percent. A rate of 7.6 percent represents approximately 11.8 million people who are unemployed. Based on the Bureau of Labor Statistics (BLS), from May 2012 to May 2013, the average employment growth was

[1] Paragraph .06 of AR section 80, *Compilation of Financial Statements*, and paragraph .08 of AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*), respectively.

169,000 per month, which is an increase over 2011. During that same time period, the number of long-term unemployed (those jobless for 27 weeks or more) has decreased by 687,000, indicating more growth in the economy. Based on the BLS, the number of people employed part-time for economic reasons decreased to 7.6 million during the first quarter of 2013, down from 8 million at the end of 2012, and the average workweek for all private employees had increased 0.1 hour through the first quarter of 2013. Together, these statistics illustrate the overall improvement in the economy.

.06 The Board of Governors of the Federal Reserve System (Federal Reserve) decreased the target for the federal funds rate more than 5.0 percentage points, from its high of 5.25 percent prior to the financial crisis, to less than 0.25 percent, where it remains into November 2013. The Federal Reserve indicates that the target range for federal funds rates of 0 percent to 0.25 percent is appropriate for as long as the unemployment rate stays above 6.5 percent, inflation over the next two years is projected to be less than 0.5 percent above the 2 percent longer-run goal, and longer-term inflation projections continue to be low.

Government Shutdown

.07 The U.S. government entered a partial shutdown on October 1, 2013, due to Congress's failure to enact legislation appropriating funds for fiscal year 2014. The shutdown lasted 16 days and was brought to an end by agreements meant to avoid defaulting on government issued debt. Both the budget and debt issues will be revisited in the near future by Congress.

.08 Several effects of the partial shutdown can be found throughout the country. The IRS is projecting a week delay in the start of the 2013 tax filing season due to lost time for development and testing of needed updates to the filing system. Another effect is the negative economic effect for areas that rely on tourism related to national parks and monuments. These attractions were closed during the shutdown and as such many travelers cancelled their travel plans. Additionally, many businesses with government contracts felt the effect in that they had to lay off employees.

Legislative and Regulatory Developments

American Taxpayer Relief Act of 2012

.09 On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (the act) after reaching an agreement to avoid the "fiscal cliff."

.10 With some modifications that increase taxes on the wealthiest Americans, the act permanently extends provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. It also permanently patches the alternative minimum tax and indexes it to inflation.

.11 The act's nontax features include one-year extensions of emergency unemployment insurance and agricultural programs and yet another postponement of automatic cuts in Medicare payments to physicians.

.12 The act temporarily extends many other tax provisions that had lapsed at midnight on December 31, 2012, and others that had expired a year earlier, reinstating them retroactively. Some of the provisions of the law that may be of interest include the following:

- Taxpayers age 70½ or older can donate up to $100,000 from Roth or traditional IRAs to certain charitable organizations without including the amount of their IRA withdrawals in gross income.
- The above-the-line deduction for qualified higher education tuition-related expenses for taxpayers with adjusted gross income below certain limits was extended.
- The deduction limitation for qualified conservation contributions is increased from 30 percent to 50 percent of the donor's contribution base over the amount of other charitable contributions.

- The deduction for contributions of apparently wholesome food from any trade or business is not limited to the taxpayer's basis in the food. The deduction is limited to 10 percent of the taxpayer's aggregate net income.

.13 Among the tax items not addressed by the act was the temporarily lower 4.2 percent rate for employees' portions of the Social Security payroll tax, which was not extended and has reverted to 6.2 percent.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.14 The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was signed into law in July 2010 in response to weaknesses in the financial services industry that are believed to have contributed to the economic recession. The main goals of the reform are to lower the systemic risks to the financial system and enhance consumer protections.

.15 The Dodd-Frank Act implements changes that affect the oversight and supervision of financial institutions and creates many new agencies. One of the main changes brought about by the Dodd-Frank Act was the creation of the Financial Stability Oversight Council (FSOC) that oversees financial institutions. The role of the FSOC, which is chaired by the Secretary of the Treasury, is to identify risks to financial stability and promote market discipline.

.16 Implementation of the Dodd-Frank Act is far behind schedule. Of the almost 400 rules that the act requires be finalized, only 161 are final as of October 1, 2013. One hundred twenty-one rules have not been proposed.

Recent AICPA Independence and Ethics Developments

Changes to Interpretation No. 101-3

.17 The AICPA's Professional Ethics Executive Committee (PEEC) adopted a number of significant revisions to Interpretation No. 101-3, "Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05).

Activities Related to Attest Services

.18 The PEEC adopted a provision clarifying that financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of the attest engagement (compilation, review, or audit) and, therefore, constitute nonattest services subject to the general requirements of Interpretation No. 101-3. This provision is effective for engagements covering periods beginning on or after December 15, 2014.

.19 This clarification does not mean that accountants and auditors cannot prepare financial statements for their review and audit clients. Instead, the accountant or auditor would have to apply the general requirements of Interpretation No. 101-3 to maintain his or her independence as a result of the preparation service. If the accountant's or auditor's independence is not impaired, the accountant or auditor can perform the review or audit.

Internal Audit Assistance Services

.20 The PEEC adopted revisions describing the effect that performing ongoing and separate evaluations would have on a member's independence. Although the revisions include a description of these two types of monitoring activities, members seeking further guidance on distinguishing between ongoing and separate evaluations are directed to the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control—Integrated Framework*.

.21 The revisions make it clear that performing ongoing evaluations is akin to accepting responsibility for maintaining the client's internal control. As such, the management participation threat is so significant that no safeguards can eliminate or reduce the threat to an acceptable level and independence would be impaired.

.22 However, when it comes to separate evaluations, the revisions clarify that members should use judgment in determining whether otherwise permitted internal audit services performed may result in a significant management participation threat to independence, considering factors such as the significance of the controls being tested, the scope or extent of the controls being tested in relation to the overall financial statements of the client, as well as the frequency of the internal audit services. If the threat to independence is considered significant, the member should apply safeguards to eliminate or reduce the threat to an acceptable level. If no safeguards could reduce the threat to an acceptable level, then independence would be impaired

.23 These revisions are effective for engagements covering periods beginning on or after December 15, 2013.

Partner Equivalents

.24 The PEEC adopted, with minor revisions, the partner equivalent proposals contained in the September 19, 2012, exposure draft. Under the adopted guidance, a partner equivalent would need to apply certain independence requirements that are applicable to partners. Partner equivalents are those professional employees who are not partners but who have (*a*) the authority to bind the firm to conduct an attest engagement[2] without partner approval or (*b*) ultimate responsibility for the conduct of an attest engagement, including the authority to sign or affix the firm's name to an attest report or to issue, or authorize others to issue, an attest report on behalf of the firm without partner approval.

.25 These revisions will be effective for engagements covering periods beginning on or after December 15, 2014. This additional time allows members to identify individuals who should be considered partner equivalents and to implement the requirements.

Ethics Codification

.26 The PEEC is proposing to restructure and codify the AICPA Code of Professional Conduct (AICPA, *Professional Standards*) (AICPA code) so that members and other users of the AICPA code can apply the rules and reach correct conclusions more easily and intuitively. To achieve this, the PEEC is proposing to restructure the AICPA code into several parts organized by topic, edit the AICPA code using consistent drafting and style conventions, incorporate a conceptual framework for members in public practice and business, revise certain AICPA code provisions to reflect the conceptual framework approach (also known as the threats and safeguard approach), and, where applicable, reference existing nonauthoritative guidance to the relevant topic. It is the PEEC's intent to maintain the substance of the existing AICPA ethics standards. The PEEC believes this was achieved; however, during the process, the PEEC identified some areas that needed revision and have been highlighted as substantive changes. The AICPA expects to issue the revised code in early 2014.

New Structure of the Code

.27 The restructured AICPA code is divided into separate parts. The first part is the preface, which is applicable to all members and covers topics such as the structure of the code; the principles of professional conduct; the defined terms that are used in the code; nonauthoritative guidance; and new, revised, and pending interpretations. The remaining three parts are divided according to a member's practice. Part 1 is applicable to members in public practice, part 2 is applicable to members in business, and part 3 is applicable to all other members, such as those who are retired or unemployed. By structuring the AICPA code this way, the PEEC believes that members will be able to easily identify what provisions apply to them. For members

[2] The AICPA Code of Professional Conduct (AICPA, *Professional Standards*) defines an *attest engagement* as "...an engagement that requires independence as defined in the AICPA professional standards."

who are both in public practice and business, content that is relevant to both parts appears in the corresponding citation (an explanation of numeric citations follows). The actual content differs only where necessary (for example, part 1 might refer to a firm, whereas part 2 might refer to employer).

Numeric Citations

.28 The new citation numbering system for the AICPA code looks like this: ET section X.XXX.XXX. The single digit that begins the citation identifies in which part the content resides. Accordingly, content from the preface begins with the single digit 0.XXX.XXX, whereas content for part 1 begins with a 1.XXX.XXX, part 2 with a 2.XXX.XXX, and part 3 with a 3.XXX.XXX. Next are two sets of three digit numbers that identify the topics and, when applicable, subtopics or sections. To facilitate use, when a topic, subtopic, or section appears in two or more parts, the same number is used.

Rules of Conduct

.29 The bylaws of the AICPA require that members adhere to the rules of the AICPA code. This has not changed with the restructured code. However, the specific rule numbers are no longer being used. For example, Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .01), is now referred to as the Independence Rule. In addition, the manner in which the interpretations are aligned with the rules has changed. In the currently effective version of the AICPA code, content is aligned under the applicable rules, whereas in the restructured AICPA code, the rules are aligned with the interpretations under a broad topic. For example, the Contingent Fees Rule and Commission and Referral Fees Rule and related interpretations will appear under ET section 1.500, "Fees and Other Types of Remuneration."

.30 Given this construct, there are some situations in which the rule appears multiple times in the AICPA code. For example, the Integrity and Objectivity Rule appears under the Integrity and Objectivity topic of both part 1 and part 2. However, the interpretations of this rule do not necessarily appear in both part 1 and part 2. Rather, they are aligned with the member's practice. For example, under the Integrity and Objectivity topic, there is a subtopic called Conflicts of Interest in both parts 1 and 2. In part 1, an interpretation addresses conflicts of interest concerns when a member in public practice is also a director of an entity. However, this interpretation does not appear in part 2 because it would not be applicable to such members.

.31 Finally, all ethics rulings have been redrafted as interpretations and codified under the appropriate topic.

Conceptual Framework

.32 The PEEC proposes to incorporate two conceptual framework interpretations into the restructured AICPA code: one for members in public practice and another very similar one for members in business. In addition, for members in public practice who provide attest services[3] to clients, there is a conceptual framework for independence that focuses on the specific threats to independence. The conceptual framework for independence is a redraft of the extant ET section 100-1, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*). These conceptual framework interpretations are designed to assist members when they encounter a relationship or circumstance that creates threats to their compliance with the rules and when the AICPA code contains no specific guidance to assist the member. When specific guidance is absent, under the conceptual framework interpretations, the member should evaluate whether that circumstance or relationship would lead a reasonable and informed third party that is aware of the relevant information to conclude that there is an unacceptable threat to the member's compliance with the rules.

.33 In addition to the two conceptual framework interpretations, certain interpretations were recast to reflect the conceptual framework approach that represents a significant change. For example, the existing interpretation that prohibits a covered member from having a direct financial interest in a client is proposed to read as follows:

[3] See footnote 2.

If a covered member had or was committed to acquire any direct financial interest in an attest client during the period of the professional engagement, the self-interest threat to the covered member's compliance with the Independence Rule would not be at an acceptable level and could not be reduced by the application of safeguards. Accordingly, independence would be impaired.

.34 The PEEC believes this will enhance understanding of the AICPA code by providing additional context to the code and guidance on the application of the framework. However, recasting will not change the substance of the existing AICPA code by allowing members to apply judgment where none is permitted today. For example, as noted in the preceding statement, if a covered member holds stock in an audit client, the only safeguard that would eliminate or sufficiently mitigate the self-interest threat to independence would be to eliminate the interest or cease being a covered member, which is the same requirement as under the current AICPA code. Thus, recasting does not weaken the code or allow for judgment where none is permitted now. Some interpretations in the code, such as those for acts discreditable, false advertising, and confidentiality, do not lend themselves to a conceptual framework approach and, as such, were not recast. For those interpretations, PEEC applied only drafting and style conventions.

Nonauthoritative Guidance

.35 The primary objectives of restructuring the AICPA code is so that members and other users can apply the code more easily, thus, minimizing the risk of misapplication. To assist members in understanding and applying the AICPA code, periodically, the Ethics division develops nonauthoritative guidance (for example, frequently asked questions and Basis for Conclusions documents) that resides outside the AICPA code. As described in ET section 0.500, "Nonauthoritative Guidance," during the restructuring, the PEEC reevaluated the nonauthoritative guidance and either proposed that some of it be made authoritative and incorporated into the revised AICPA code or aligned links to the nonauthoritative content with the relevant topic.

Current Practice Issues

.36 The AICPA staff has identified some challenging practice issues and in this section, we provide recommendations to assist practitioners in addressing them in an efficient, high quality manner.

Engagement Letters

.37 Paragraph .02 of AR section 80, *Compilation of Financial Statements*, and paragraph .03 of AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*), require that the accountant establish an understanding with management regarding the services to be performed and document the understanding through a written communication with management for compilation and review engagements, respectively. An engagement letter is the most common, and usually the most convenient, method for documenting the understanding with management regarding the services to be performed. A formal contract is another suitable form of written agreement. A verbal understanding with management is insufficient.

.38 Current SSARSs do not require that the engagement letter be signed by either the accountant or management. However, the purpose of the engagement letter is to ensure that both the accountant and management understand the objectives of the engagement, management's responsibilities, the accountant's responsibilities, and the limitations of the engagement. Having both parties sign the engagement letter evidences agreement on those important aspects of the engagement and therefore is considered a very strong best practice. The proposed SSARSs *Preparation of Financial Statements, Compilation Engagements*, and *Review of Financial Statements* will require that the engagement letter be signed by both the accountant and management for all engagements to prepare financial statements, perform a compilation of financial statements, or perform a review of financial statements, respectively.

.39 Both current and proposed SSARSs, however, leave the period that the engagement letter should cover to the accountant's judgment. The engagement letter can cover multiple services and address both nonattest and attest services (for example, an engagement to prepare monthly financial statements and review the annual financial statements for an entity). Some practitioners use what is often referred to as "evergreen letters," which cover multiple years or may run in perpetuity. Although not prohibited, the practice of obtaining such multiyear or evergreen engagement letters is strongly discouraged because the understanding between the accountant and management tends to lose clarity as time passes. This practice may also create the perception of the engagement being a "continuous" one, thereby potentially prolonging the point in time at which a statute of limitations may start to run. From a risk management perspective, an accountant can mitigate the risk of an engagement being considered "continuous" by obtaining a new engagement letter at least annually.

Subsequent Events

.40 In a review engagement, the accountant is required to consider inquiring of the client's management concerning subsequent events that could have a material effect on the financial statements. If management advises the accountant that such subsequent events exist, the accountant should request that management consider the possible effects on the financial statements, including adequate disclosure. If the subsequent event is not properly accounted for or disclosed, the accountant should modify the accountant's review report to disclose the departure from the applicable financial reporting framework. The management representation letter should also include a statement by management that subsequent events have been appropriately reflected in the financial statements.

.41 In a compilation engagement, the accountant does not have any responsibility with respect to subsequent events unless evidence or information about a subsequent event that has a material effect on the financial statements comes to the accountant's attention. If such evidence or information comes to the accountant's attention, the accountant should request that management consider the possible effects on the financial statements, including adequate disclosure. If the subsequent event is not properly accounted for or disclosed, the accountant should modify the accountant's compilation report to disclose the departure from the applicable financial reporting framework.

.42 Since the accountant's compilation or review report is dated as of the completion of the compilation or review procedures, the date of the report can never be earlier than the date that management discloses as the date through which subsequent events were evaluated. In a review engagement, the accountant's review report, the representation, and the note disclosure should all be dated as of the same date. The accountant may want to discuss these dating issues with management prior to the start of the engagement and include them in the engagement letter.

Review Evidence and Analytical Procedures in a Review Engagement

.43 Many accountants have come to consider the review engagement as an exercise in performing analytical procedures and making inquiries of management. However, a review is more than that; a review is an assurance engagement and requires the accumulation of review evidence that will provide the accountant with limited assurance that there are no material modifications that should be made to the financial statements.

.44 The use of analytical procedures in a review differs from their use in an audit. In an audit, analytical procedures are both an important part of planning the audit engagement and a substantive procedure. Essentially, an auditor is required to utilize analytical procedures in both the planning and overall review stages of all financial statement audits, and these types of procedures also frequently are utilized to complement other substantive procedures used in performing engagements; in very low risk areas, analytical procedures may be the only substantive procedures used related to auditing certain amounts in the financial statements. In a review, the accountant is not required to perform analytical procedures in the planning or overall review stages of the engagement. Instead, the results of the analytical procedures represent review evidence the accountant obtains to support the accountant's review report.

.45 Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, with expectations the accountant develops. Two general steps in performing analytical procedures are as follows:

- Developing expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant's understanding of the entity and the industry in which the entity operates
- Comparing the recorded amounts, or ratios developed from recorded amounts, with the expectations the accountant develops

.46 The accountant develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant's understanding of the industry in which the client operates and knowledge of the client's business.

Example: If an accountant is engaged to review the financial statements of a private school, the accountant might develop expectations for net tuition revenue by obtaining the number of students by grade level, tuition pricing by grade level, policies for discounts applicable to families with multiple students, tuition assistance approved by the school's board, and other data points, many of which are from nonaccounting sources. With this information, the accountant can calculate an expected value for net tuition revenue by first determining the disaggregated components of revenue as follows:

Gross Tuition

Less:

Discounts applicable to families having multiple children enrolled

Less:

Tuition assistance

Equals:

Net tuition

.47 In accordance with paragraph .18 of AR section 90, the accountant should investigate any fluctuations or relationships that differ from expected values by a significant amount by inquiring of management and performing other procedures as necessary in the circumstances. For additional illustrative examples of analytical procedures and more detailed guidance on evaluating the actual results of analytical procedures, readers should refer to the AICPA Guide *Compilation and Review Engagements* and appendix A, "Illustrative Analytical Procedures for Review Engagements," of this alert.

Reporting on Supplementary Information in a Compilation or Review Report

.48 Regardless of whether the financial statements are compiled or reviewed, the accountant should clearly indicate the degree of responsibility, if any, he or she is taking with respect to information presented for supplementary analysis purposes. When the accountant has compiled both the basic financial statements and other data presented only for supplementary analysis purposes, the compilation report should refer to the other data, or the accountant can issue a separate report on the other data. When the accountant has reviewed the basic financial statements, an explanation should be included in the review report or in a separate report on the other data. The report should state that the review has been made for the purpose of expressing a conclusion that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework and that either

- the other data accompanying the financial statements are presented only for purposes of additional analysis and have been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and the accountant did not become aware of any material modifications that should be made to such data; or
- the other data accompanying the financial statements are presented only for purposes of additional analysis and have not been subjected to the inquiry and analytical procedures applied in the review

of the basic financial statements but were compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or provide any assurance on such data.

.49 Unless engaged to review or compile supplementary information, the SSARSs do not require the accountant to apply procedures to any information presented for supplementary analysis purposes, including required supplementary information. Although not specified in the SSARSs, the location of the explanation in the accountant's report (when the accountant does not issue a separate report on the supplementary information) that addresses the supplementary information is typically at the end of the accountant's compilation or review report in a separate paragraph. For illustrative examples of an accountant's compilation or review report containing the explanatory language required for supplementary information, readers are encouraged to refer to the *Compilation and Review Engagements* guide.

> **Required Supplementary Information:**Interpretation No. 17, "Required Supplementary Information That Accompanies Compiled Financial Statements," of AR section 80 (AICPA, *Professional Standards*, AR sec. 9080 par. .66), and Interpretation No. 11, "Required Supplementary Information That Accompanies Reviewed Financial Statements," of AR section 90 (AICPA, *Professional Standards*, AR sec. 9090 par. .44), as applicable, provide guidance when an accountant is engaged to compile or review financial statements that a designated accounting standard setter (such as the Financial Accounting Standards Board [FASB] or the Governmental Accounting Standards Board) requires be accompanied by required supplementary information and such required supplementary information is omitted.

Variable Interest Entities

.50 Accountants engaged to compile or review financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) should consider whether the requirements concerning variable interest entities (VIEs) are applicable to the financial statements. Paragraph 38A of FASB *Accounting Standards Codification[ae]* (ASC) 810-10-25 requires a reporting entity with a variable interest in a VIE to assess whether the reporting entity has a controlling financial interest in the VIE and, thus, is the VIE's primary beneficiary.

.51 As background, such an assessment should include an assessment of the characteristics of the reporting entity's variable interest(s) and other involvements (including involvement of related parties and de facto agents), if any, in the VIE, as well as the involvement of other variable interest holders. Additionally, the assessment should consider the VIE's purpose and design, including the risks that the VIE was designed to create and pass through to its variable interest holders.

.52 A reporting entity is deemed to have a controlling financial interest in a VIE if it has both of the following characteristics:

a. The power to direct the activities of a VIE that most significantly affect the VIE's economic performance

b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE

.53 Only one reporting entity, if any, is expected to be identified as the primary beneficiary of a VIE. Although more than one reporting entity could have the characteristic in (*b*), only one reporting entity, if any, will have the power to direct the activities of a VIE that most significantly affect the VIE's economic performance.

.54 Practitioners often find that, in practice, management refuses to perform the required assessment and instructs the accountant engaged to compile or review the financial statements not to perform the assessment.

So, accountants often wonder whether this scenario is cause for the accountant to withdraw from the engagement due to management's refusal to provide information or because of a scope limitation. Technical Questions and Answers (TIS) section 9150.29, "Effects on Compilation and Review Engagements When Management Does Not Assess Whether the Reporting Entity Is the Primary Beneficiary of a Variable Interest Entity and Instructs the Accountant to Not Perform the Assessment" (AICPA, *Technical Practice Aids*), provides that the accountant is not required to withdraw from the engagement as the failure to perform the assessment and management's instructions to the accountant not to perform the assessment are a departure from GAAP, not a refusal to provide information or a scope limitation. Instead, the accountant should consider whether modification of the standard report is adequate to disclose this departure from GAAP. The full text of this nonauthoritative TIS section provides more guidance.

Applicability of the Compilation Standards When Performing Controllership or Other Management Services

.55 Paragraph .01 of AR section 80 requires the accountant to comply with the provisions of AR section 80 whenever he or she submits financial statements to a client or to third parties. *Submission of financial statements*[4] is defined in AR section 60, *Framework for Performing and Reporting on Compilation and Review Engagements* (AICPA, *Professional Standards*), as presenting to management financial statements that the accountant has prepared.

.56 Members in public practice[5] often accept engagements to perform controllership or other management services for their clients. If the accountant is in public practice and is not a stockholder, partner, director, officer, or employee of the entity, the accountant is required to comply with the requirements of AR section 80.

.57 If the accountant is a stockholder, partner, director, officer, or employee of the entity, the accountant is not required to comply with the requirements of AR section 80. If the accountant in public practice determines that he or she does not want to comply with the requirements of AR section 80, the accountant may issue a communication that makes clear the accountant's involvement in the preparation of the financial statements. Though such communication need not be in writing, an example is as follows:

> The accompanying balance sheet of Company X as of December 31, 20XX, and the related statements of income and cash flows for the year then ended have been prepared by [*name of accountant*], CPA. I have prepared such financial statements in my capacity [*describe capacity, for example, as a director*] of Company X.

.58 If the accountant is not in the practice of public accounting, the issuance of a report in accordance with SSARSs would be inappropriate. However, the preceding report may be used.

.59 Questions concerning whether the accountant is in public practice are often difficult and the accountant may wish to consult with the AICPA Professional Ethics Hotline.

Reference to the Accountant's Report in Notes to the Financial Statements

.60 Paragraph .18 of AR section 80 and paragraph .29 of AR section 90 require that each page of the financial statements that were compiled or reviewed by the accountant include a reference such as "See accountant's compilation report," "See independent accountant's compilation report," or "See accountant's review report." Given that the financial statements are management's responsibility, this may be a challenging requirement to meet. Often, management is willing to include such a reference on the face of the balance sheet and related statements but not on the notes.

.61 Because the related notes are an integral part of the financial statements, the requirement does extend to the notes. If the accountant is unable to have management include the reference on each page of financial

[4] See the "On the Horizon" section of this alert for information on proposed Statements on Standards for Accounting and Review Services that would change the applicability of the compilation standards.

[5] *Public practice* is defined in paragraph .30 of ET section 92, *Definitions* (AICPA, *Professional Standards*), as consisting of the performance of professional services for a client by a member or a member's firm.

statements (which includes the notes), in accordance with paragraph .11 of AR section 60, the accountant should document the justification for the departure from the SSARSs requirements.

Reporting When a Different Level of Service Is Applicable to the Prior Period

Prior Period Is Audited

.62 When reporting on current period compiled or reviewed financial statements, and the prior period financial statements were audited, the requirements of paragraph .29 of AR section 200, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*), are applicable. This paragraph provides that the accountant should issue an appropriate compilation or review report on the current-period financial statements and, if the auditor's report on the prior period financial statements is not reissued, the report on the current period should include as a separate paragraph an appropriate description of the responsibility assumed for the financial statements of the prior period. The separate paragraph should indicate all of the following:

a. That the financial statements of the prior period were audited previously

b. The date of the previous report

c. The type of opinion expressed previously

d. If the opinion was other than unmodified, the substantive reasons therefor

e. That no auditing procedures were performed after the date of the previous report

These provisions apply regardless of whether the accountant is the continuing accountant or successor accountant.

Prior Period Compiled or Reviewed—Continuing Accountant

.63 In accordance with paragraph .08 of AR section 200, a continuing accountant who performs a higher level of service with respect to the financial statements of the current period should update his or her report on the financial statements of a prior period presented with those of the current period. A continuing accountant who performs a lower level of service with respect to the financial statements of the current period should either (*a*) include as a separate paragraph of his or her report a description of the responsibility assumed for the financial statements of the prior period or (*b*) reissue his or her report on the financial statements of the prior period. Please see the preceding section for additional guidance when the prior period financial statements were audited.

Illustrative Accountant's Reports

.64 The accountant should refer to paragraphs .38–.39 of AR section 200 for illustrative accountant's compilation and review reports on comparative financial statements when different levels of service were applicable to the periods presented.

Prior Period Compiled or Reviewed by a Predecessor Accountant

.65 In accordance with paragraph .17 of AR section 200, when the financial statements of a prior period have been compiled or reviewed by a predecessor whose report is not presented and the successor has not compiled or reviewed those financial statements, the successor should make reference in an additional paragraph(s) of his or her report on the current-period financial statements to the predecessor's report on the prior-period financial statements. This reference should include the following matters:

a. A statement that the financial statements of the prior period were compiled or reviewed by another accountant (other accountants)

b. The date of his or her (their) report *c.* If the financial statements of the prior period were compiled, a statement that the other accountant(s) did not audit or review the financial statements and, accordingly, did not express an opinion or provide any assurance about whether the financial statements are in accordance with the applicable financial reporting framework

d. If the financial statements of the prior period were reviewed, a statement that, based on his or her review, the other accountant(s) are not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework, other than those modifications, if any, indicated in the report

e. A description or a quotation of any modifications of the standard report and of any paragraphs emphasizing a matter regarding the financial statements

Bookkeeping and Financial Statement Preparation Services

.66 For years, members have called the AICPA's Technical Hotline and inquired at conferences whether certain actions meant they had "submitted" financial statements. For example, if a CPA was performing bookkeeping services for the client and the client "pushed the button" to print the financial statements, many CPAs would claim that they have not "submitted" the financial statements. The fact that the client "pushed the button" meant that the client (or more accurately, the client's software) prepared the financial statements. Other CPAs might, legitimately, argue the opposite. So too would some members argue that even if they pushed the button, they didn't prepare the financial statements because all they did was prepare adjustments at month's end.

.67 Currently, the compilation standards are applicable when the accountant is engaged to report on compiled financial statements or submits financial statements to a client or to third parties. Further, in SSARSs, *the submission of financial statements* is defined as "presenting to management financial statements that an accountant has prepared." Therefore, the compilation standards apply today when the CPA is either (1) engaged to perform a compilation, or (2) when the CPA prepares financial statements on behalf of management. Accountants may refer to TIS section 9150.25, "Determining Whether Financial Statements Have Been Prepared by the Accountant" (AICPA, *Technical Practice Aids*), for guidance regarding when the work that they have performed results in financial statement preparation.

.68 The proposed SSARS would eliminate the submission requirement and make the compilation literature apply only when the accountant is engaged to perform a compilation service.

.69 This proposed revised SSARS, and other proposed SSARSs, are discussed further in the "On the Horizon" section of this alert.

Peer Reviews of Compilation and Review Engagements

Matters for Consideration

.70 In performing peer review engagements, peer reviewers use Matter for Further Consideration (MFC) forms to document issues identified based on the review of individual engagements or the firm's system of quality control. The MFC form captures issues at the most granular level. Matters included on these forms may stay as matters or may be elevated to findings or deficiencies. A matter is noted as a result of evaluating whether an engagement submitted for review was performed and reported on in conformity with applicable professional standards. The evaluation includes reviewing the financial statements or information, the related accountant's reports, and the adequacy of procedures performed, including related documentation.

.71 Depending on the resolution of a matter and the process of aggregating and evaluating peer review results, a matter may develop into a finding. Findings will also be evaluated and, after considering their nature and relative importance, including whether they are material to the understanding of the report or financial statements, or represent the omission of a critical procedure including documentation, may not get elevated to a deficiency. Alternatively, a matter may develop into a finding and get elevated to a deficiency. That deficiency may or may not be further elevated to a significant deficiency.

.72 In 2012, the AICPA Peer Review Program reported that approximately 34,600 engagements were reviewed, of which approximately 22,600 were compilation or review engagements. Based on peer reviews performed during 2010-2012, the items that follow were common examples of noncompliance (both material and immaterial) with professional standards.

Common Peer Review Findings—Review Engagements

Analytical Procedures—Failure to Document Expectations When Performing Analytical Procedures and to Compare Results to Those Expectations

.73 For the relevant authoritative guidance applicable to this finding, practitioners should review paragraphs .25–.26 of AR section 90, which describe the accountant's documentation requirements in a review engagement. These requirements include documenting the expectations for analytical procedures performed and the factors considered in the development of the expectations.

Management Representations—Omissions and Errors

.74 For the relevant authoritative guidance applicable to this finding, practitioners should review paragraphs .22–.24 of AR section 90, which explain that written representations from management are required for all financial statements and periods covered by the accountant's review report. The accountant should request that management provide a written representation related to the following matters:

- Management's acknowledgment of its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- Management's belief that the financial statements are fairly presented in accordance with the applicable financial reporting framework
- Management's acknowledgement of its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements
- Management's acknowledgement of its responsibility to prevent and detect fraud
- Knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others
- Management's full and truthful response to all inquiries
- Completeness of information
- Information concerning subsequent events

.75 The representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry.

Basic Reporting Elements—Failure to Follow the Basic Report Elements

.76 Practitioners should note that financial statements reviewed by the accountant should be accompanied by a written report. Paragraphs .27–.33 of AR section 90 describe the reporting requirements. The basic elements of the report are as follows:

- Title
- Addressee
- Introductory paragraph

- Management's responsibility for the financial statements
- Accountant's responsibility
- Results of engagement
- Signature of the accountant
- Date of the accountant's report

Engagement Letters—Omissions and Errors

.77 Readers should refer to the "Current Practice Issues" section of this alert for information on engagement letters.

Reporting on Comparative Financial Statements—Referencing All Periods Reviewed and to Supplemental Information Provided in the Accountant's Review Report

.78 For the relevant authoritative guidance applicable to this finding, practitioners should review AR section 200, which describes the requirements for reporting on comparative financial statements. See also paragraph .60 of AR section 90 and paragraph .53 of AR section 80 for the requirements applicable to reporting on supplementary information, and the "Current Practice Issues" section of this alert for more information on reporting on comparative financial statements.

Common Peer Review Findings—Compilation Engagements

Failure to Properly Modify Accountant's Compilation or Review Report for a Departure From GAAP Resulting From Financial Statements Containing Current Liabilities Without the Appropriate Caption

.79 Paragraph 4 of FASB ASC 210-10-05 states that the balance sheets of most entities show separate classifications of current assets and current liabilities (commonly referred to as classified balance sheets) permitting ready determination of working capital. FASB ASC 210-10-45 establishes the requirements for presenting comparative financial statements. Failure to properly classify current assets and current liabilities in a classified balance sheet is a departure from GAAP. Paragraphs .27–.29 of AR section 80 and paragraphs .34–.36 of AR section 90 require that if the financial statements are not revised, the accountant should consider whether modification of the standard report is adequate to disclose the departure. If the accountant concludes that modification of the standard report is appropriate, the departure should be disclosed in a separate paragraph of the report, including disclosure of the effects of the departure on the financial statements if such effects have been determined by management or are known as a result of the accountant's procedures. If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements as a whole, the accountant should withdraw from the engagement and provide no further services with respect to those financial statements.

Failure to Appropriately Title Financial Statements

.80 Practitioners should note that financial statements require suitable titles. Examples of these titles with respect to financial statements prepared in accordance with GAAP include balance sheet, statement of comprehensive income or statement of net income and comprehensive income, statement of retained earnings or changes in shareholders' equity, and statement of cash flows. Other suitable titles can be found in chapter 2, "Compilation Engagement Performance Requirements," of the *Compilation and Review Engagements* guide.

.81 If the financial statements are not suitably titled, the accountant should consider modification of the accountant's compilation or review report to disclose the departure from the applicable financial reporting framework.

Reporting on the Financial Statements—Failure to Include Basic Report Elements

.82 Paragraph .17 of AR section 80 lists the basic elements of the accountant's compilation report, which include the following:

- Title
- Addressee
- Introductory paragraph
- Paragraph describing management's responsibility
- Paragraph describing accountant's responsibility
- Results of engagement
- Signature of the accountant
- Date of the accountant's report

.83 The introductory paragraph should specify the date or period(s) covered by the financial statements.

Inappropriate Form of a Standard Compilation Report—Failure to Identify the Non-GAAP Financial Reporting Framework Used

.84 The applicable financial reporting framework should be included in the compilation report as described in paragraphs .17 and .19 of AR section 80.

> **AICPA Peer Review Program:** Training and frequently asked questions about the AICPA Peer Review program can be found at www.aicpa.org/InterestAreas/PeerReview/Pages/PeerReviewHome.aspx. Questions can also be directed to the Peer Review Hotline at 919.402.4502 or prptechnical@aicpa.org.

Financial Reporting Framework for Small- and Medium-Sized Entities

.85 The AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs™) is designed for America's small business community. It delivers financial statements that provide useful, relevant information in a simplified, consistent, cost-effective way. The FRF for SMEs framework may be used when GAAP are not required.

.86 The FRF for SMEs accounting framework draws upon a blend of traditional accounting principles and accrual income tax methods of accounting. It utilizes historical cost as its primary measurement basis. In addition, it provides management with a suitable degree of optionality when choosing accounting policies to better meet the needs of the end users of the financial statements. The framework avoids prescriptive, detailed standards and voluminous disclosure requirements. Being a more intuitive and understandable framework for small business owners and the users of their financial statements, the framework lays out principles that encourage the use of professional judgment in the particular circumstances of a transaction or event.

.87 The AICPA believes that the framework is criteria suitable for general use financial statements and can be used by users external to the entity. An important pillar of the framework is that its use requires the exercise of professional judgment. The key attributes of the framework are as follows:

- Objectivity. The framework is free from bias.
- Measurability. The framework permits reasonably consistent measurements.

- Completeness. The framework is sufficiently complete so that those relevant factors that would alter a conclusion about the financial statements are not omitted.
- Relevance. The framework is relevant to financial statement users.

Scope and Characteristics of Entities Utilizing the FRF for SMEs Accounting Framework

.88 The FRF for SMEs accounting framework has been developed for small- to medium-sized entities that require reliable non-GAAP financial statements for internal use and external uses. The framework can be used by entities in many industry groups and may also be used by unincorporated, as well as incorporated, entities. The framework is not intended to be a substitute for GAAP when GAAP-based financial statements are necessary, as determined by the management of a private company and its financial statement users.

.89 A standard definition of small- and medium-sized entities does not exist in the United States of America. However, the term is intuitive, widely recognized, and effectively descriptive of the scope of entities for which the FRF for SMEs accounting framework is intended. Size criteria for determining what is a small- or medium-sized entity were deliberately not developed to quantify size. Rather, characteristics of typical entities that may utilize the framework are presented. Ultimately, the decision regarding which accounting framework best meets an entity's financial reporting needs rests with management.

.90 This list presents certain characteristics of typical entities that may utilize the FRF for SMEs accounting framework. These characteristics are not all-inclusive and are not presented as a list of required characteristics an entity must possess in order to utilize the framework:

- The entity does not have regulatory reporting requirements that essentially require it to use GAAP-based financial statements.
- A majority of the owners and management of the entity have no intention of going public.
- The entity is for-profit.
- The entity may be owner-managed, which is a closely held company in which the people who own a controlling ownership interest in the entity are substantially the same set of people who run the company.
- Management and owners of the entity rely on a set of financial statements to confirm their assessments of performance, cash flows, and of what they own and what they owe.
- The entity does not operate in an industry such as financial or government in which the entity is involved in transactions that require highly-specialized accounting guidance.
- The entity does not engage in overly complicated transactions.
- The entity does not have significant foreign operations.
- Key users of the entity's financial statements have direct access to the entity's management.
- Users of the entity's financial statements may have greater interest in cash flows, liquidity, statement of financial position strength, and interest coverage.
- The entity's financial statements support applications for bank financing when the banker does not base a lending decision solely on the financial statements but also on available collateral or other evaluation mechanisms not directly related to the financial statements.

Application of FRF for SMEs Accounting Framework Principles, Concepts, and Criteria

.91 The FRF for SMEs accounting framework was developed to address transactions that are typically encountered by private, for-profit, small-, and medium-sized entities. If the framework does not specifically address a transaction, other event, or condition, management should use its judgment and apply the general principles, concepts, and criteria contained in the framework when developing accounting policies. The development and application of those policies should result in financial information that is intended to be consistent with the financial statement concepts of the FRF for SMEs accounting framework.

Authority and Effective Date of the FRF for SMEs Accounting Framework

.92 The AICPA has no authority to require the use of the FRF for SMEs accounting framework for any entity. Therefore, use of the framework is purely optional. Management that prepares an entity's financial statements in accordance with the framework may represent or assert that such financial statements have been prepared in accordance with the AICPA's FRF for SMEs accounting framework, a special purpose framework.

.93 Because use of the framework is optional, there is no effective date for its implementation.

Maintenance of the FRF for SMEs Accounting Framework

.94 Appreciating the limited accounting resources that typical entities utilizing the FRF for SMEs accounting framework have, as well as the nature of their financial reporting, the framework is intended to be a stable platform that does not undergo frequent amending or updating. At the same time, it is intended to be responsive to the financial reporting needs of small- and medium-sized entities and, therefore, will be modified in response to significant developments in accounting and financial reporting matters affecting those entities.

.95 Accordingly, the task force and AICPA staff intend to monitor and assess input related to the implementation of the framework after its initial release and propose modifications as necessary. Afterwards, staff, with assistance from the task force, intends to review and propose amendments to the framework approximately every three or four years. Amendments will be primarily based on input from stakeholders and developments in accounting and financial reporting.

FRF for SMEs Toolkits

.96 The AICPA has developed free FRF for SMEs toolkits to help CPAs and CPA firms, financial statement users and small businesses learn about the FRF for SMEs reporting option. These toolkits contain overviews, sample illustrative financial statements, videos, PowerPoint presentations, and much more. There are three toolkits available: one for CPAs, one for financial statement users, and one for small businesses.

.97 The CPA firm toolkit provides both client facing and internal resources to help make the transition to the FRF for SMEs framework easier. The client facing materials include videos that highlight key benefits of the framework and a PowerPoint presentation to help practitioners introduce the framework to clients. The internal materials include a learning and implementation plan to help the practitioner plan and track the use of the items in the toolkit and training materials to use with your firm employees on the framework.

.98 The AICPA has created several resources to help users of financial statements understand the framework. These resources include illustrative financial statements, comparisons of the FRF for SMEs accounting framework to GAAP, tax basis, and other accounting frameworks, as well as frequently asked questions.

.99 The toolkit for small business includes a decision tool to help the company make an informed decision about choosing an accounting framework, a backgrounder that outlines why the FRF for SMEs framework was needed, and a template for a letter to stakeholders expressing your interest in using the FRF for SMEs framework.

.100 All of the resources are available free of charge at www.aicpa.org/INTERESTAREAS/FRC/ACCOUNTINGFINANCIALREPORTING/PCFR/Pages/Financial-Reporting-Framework.aspx.

.101 The AICPA's Accounting and Auditing Technical Hotline also provides members with free, high-quality technical assistance by phone concerning issues related to accounting and financial reporting, auditing and attestation, compilation, and review standards. Technical questions about the FRF for SMEs accounting framework can be directed to the technical hotline.

Decision Tool for Adopting FRF for SMEs

.102 Financial reporting frameworks consist of two groups: GAAP and special-purpose frameworks (SPFs). Special purpose frameworks, with the exception of the contractual basis of accounting, are commonly referred to as other comprehensive bases of accounting or OCBOA. Special purpose frameworks include cash basis, modified cash basis, tax basis, regulatory basis, contractual basis, and other non-GAAP bases of accounting that utilize a definite set of logical, reasonable criteria that are applied to all material items appearing in the financial statements. The FRF for SMEs framework is a special purpose framework.

.103 The AICPA has developed a tool to help owners and managers of a small- or medium-sized private business and CPAs serving those businesses to make an informed decision about choosing an accounting framework, including the FRF for SMEs framework, as an appropriate basis for the preparation of the entity's financial statements. The choice of a financial reporting framework rests with the owners and managers of a private company, in consideration of their needs and the needs of the users of their financial information. The tool is available online to AICPA members at the AICPA's Financial Reporting Center at www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/PCFR/DownloadableDocuments/FRF-SME/FRFforSMEs_DecisionTool.pdf.

.104 Management of an entity and the CPA practitioners who serve those entities may find the tool helpful in determining which accounting framework (or basis of accounting) is most suitable for the entity's financial reporting needs. By following the steps and assessing the considerations and circumstances outlined in the tool, a more informed decision about the choice of an accounting framework can be made. Readers should note that the tool is presented as a nonauthoritative aid and its use is not required.

AICPA Practice Aid *Accounting and Financial Reporting Guidelines For Cash- and Tax-Basis Financial Statements*

.105 Readers should also be aware that, should the cash-basis or tax-basis frameworks be more appropriate for an entity, the AICPA has available a practice aid *Accounting and Financial Reporting Guidelines For Cash- and Tax-Basis Financial Statements* that provides preparers with the guidelines and best practices to promote consistency and help resolve the often difficult questions regarding the preparation of cash- and tax-basis financial statements. Although nonauthoritative, this practice aid is the best source for such guidance. You can order this practice aid from www.cpa2biz.com (product no. APACTB12P [paperback], ACACTB12E [eBook], or APACTBO [online]).

Recent Activities of FASB's Private Company Council

.106 In May 2012, the Financial Accounting Foundation's Board of Trustees approved the establishment of the Private Company Council (PCC) to improve the standard-setting process for private companies. At the PCC's February 12, 2013, meeting, FASB and the PCC tentatively agreed on the criteria for determining whether and in what circumstances private companies should have alternatives within GAAP. Using those criteria, the PCC will develop, deliberate, and formally vote on proposed alternatives for private companies within GAAP. If endorsed by FASB, the proposed alternatives will be exposed for public comment. At the conclusion of the public comment process, the PCC will redeliberate the proposed alternatives and then submit them to FASB for a final decision on endorsement. FASB and the PCC also will use this guide to consider private company issues in standard-setting projects under active consideration on FASB's technical agenda.

.107 In June 2013, FASB endorsed three alternatives within GAAP that were proposed by the PCC. The proposals involve accounting for intangible assets acquired in business combinations, goodwill, and certain types of interest rate swaps. Exposure drafts are expected to be issued for public comment.

.108 The first proposal—derived from PCC Issue No. 13-01A, *Accounting for Identifiable Intangible Assets in a Business Combination*—modifies the requirement for private companies to separately recognize fewer intangible assets acquired in a business combination.

.109 The second proposal—derived from PCC Issue No. 13-01B, *Accounting for Goodwill Subsequent to a Business Combination*—would permit amortization of goodwill (the residual asset recognized in a business combination after recognizing all other identifiable assets acquired and liabilities assumed) and a simplified goodwill impairment model.

.110 The third proposal—derived from PCC Issue No. 13-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps*—would give private companies, other than financial institutions, the option to use two simpler approaches to accounting for certain types of interest rate swaps that are entered into by a private company for the purpose of economically converting its variable-rate borrowing to a fixed-rate borrowing.

.111 The effective dates will be determined after FASB and the PCC consider stakeholder feedback on the exposure drafts.

.112 In September 2013, FASB voted to propose changes designed to improve the relevance and reduce the complexity of development-stage entity financial reporting and expects to issue an exposure draft by the end of October that would apply to public and private entities.

On the Horizon

.113 Practitioners and management should keep abreast of accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to compilations and reviews. Remember that exposure drafts are nonauthoritative and cannot be relied upon until issued as a final, approved standard.

.114 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard-setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. For projects that the Accounting and Review Services Committee (ARSC) has undertaken, readers should refer to the AICPA's Financial Reporting Center at www.aicpa.org/RESEARCH/STANDARDS/COMPILATIONREVIEW/ARSC/Pages/ARSC.aspx.

SSARSs Clarity Project, Including Significant Changes to the Compilation Standards

Proposed SSARSs Preparation of Financial Statements, Compilation Engagements, and *Association With Financial Statements*

.115 In October 2013, the ARSC exposed for public comment three proposed standards that, if passed as final standards, would significantly affect the literature for compilation engagements. The proposed standards are written in clarity format and have a comment end date of May 2, 2014. The proposed standards are as follows:

- A proposed revised compilation standard that would provide requirements and guidance to an accountant when engaged to perform a compilation engagement on historical financial statements.
- A new standard that would provide requirements and guidance when an accountant is engaged to prepare financial statements for a client but has not been engaged to perform a compilation, review, or audit with respect to those financial statements.
- A new standard that would provide requirements and guidance when an accountant agrees to permit the use of his or her name in a report, document, or written communication that also includes

financial statements with respect to which the accountant did not issue a compilation, review, or audit report. The accountant may or may not have prepared the financial statements.

.116 The proposed revised compilation standard would revise the applicability of the compilation literature. Currently, AR section 80 applies when an accountant is engaged to report on compiled financial statements or submits financial statements to the client or to third parties. *Submission* is defined as "prepares and presents." Although submission worked satisfactorily as a trigger for the compilation service when SSARS No. 1 was issued in December 1978, cloud computing and other applications have made it difficult to determine who (or what) has prepared the financial statements. Take, for example, a situation in which an accountant performs bookkeeping services for a client. Perhaps the accountant has access to the client's cloud computing system and makes a few journal entries to record payroll tax payments, sales tax payments, and depreciation expenses for a given period. The company's internal bookkeeper records certain recurring expenses such as utilities and office expenses. At the end of each month, the bookkeeper prints out a copy of the financial statements for presentation to the board of directors. Has the accountant prepared those financial statements? The bookkeeper? The application itself?

.117 The ARSC proposal would eliminate the need for the accountant to determine an answer to that difficult question by eliminating the submission requirement and making the compilation literature apply when the accountant is engaged to perform a compilation service. Since the accountant would follow the compilation standard when engaged, the accountant would always be required to issue a compilation report. However, in order to differentiate the nonassurance compilation report from assurance (review and audit) reports, the ARSC has proposed to streamline the report so that the standard report is just one paragraph with no headings.

.118 The proposed standard would retain the existing requirement that the accountant modify the accountant's compilation report whenever the accountant's independence is impaired. The accountant would be required to obtain an engagement letter signed by both the accountant and the client's management. The proposed standard can be applied to financial statements with or without disclosures.

.119 The proposed preparation standard would apply when the accountant is engaged to prepare financial statements but is not engaged to perform an audit, review, or a compilation on those financial statements. A report would not be required—even when financial statements are expected to be used by or presented to a third party. Instead, the accountant would be required to include a legend on each page of the financial statements stating that no assurance is being provided. The proposed SSARS would require that the accountant obtain an engagement letter signed by both the accountant and the client's management. Like all other nonattest bookkeeping and accounting services engagements, the accountant would not be required to consider whether he or she is independent. The proposed standard can be applied to financial statements with or without disclosures.

.120 The proposed compilation and preparation SSARSs would result in a bright line between accounting (preparation) and reporting (compilation) services. The accountant would not have to be concerned about whether the financial statements would be used internally or would be used by third parties (including boards of directors). The following table illustrates the similarities and differences between the two proposed services:

	Compilation	*Preparation*
When does the standard apply?	When an accountant is engaged to perform a compilation.	When an accountant is engaged to prepare financial statements.
Is an engagement letter required?[6]	Yes	Yes
Is the accountant required to determine if he or she is independent of the client?	Yes	No
If the accountant is not independent, is that fact required to be disclosed?	Yes	N/A
Does the engagement require a report?	Yes	No, except if management refuses to include required disclosure that no CPA provides any assurance.
May the financial statements go to users outside of management?	Yes	Yes
May the financial statements omit substantially all notes?	Yes	Yes

.121 The proposed association standard is essentially the same as pre-clarity AU section 504, *Association With Financial Statements.* The requirements and guidance with respect to association with unaudited financial statements is being moved to the SSARSs so that the auditing literature deals only with audit matters. The proposed standard applies when the accountant permits the use of his or her name in a report, document, or written communication containing financial statements that the accountant has not issued an audit, review, or compilation report on. In those cases, the accountant would be required to read the financial statements to see if there are any obvious material misstatements.

Proposed SSARSs, Review of Financial Statements and *Review of Financial Statements—Special Considerations*

.122 In addition to the trio of proposed standards that were exposed for public comment in October 2013, the ARSC had previously exposed for public comment a pair of SSARSs dealing with reviews of financial statements. The proposed SSARSs are converged with the requirements of AU-C section 930, *Interim Financial Information* (AICPA, *Professional Standards*). The result will be consistency between limited assurance engagements. Additionally, the proposed SSARSs may be applied to historical financial information other than historical financial statements such as the following:

- Specified elements, accounts, or items of a financial statement
- Supplementary information
- Required supplementary information
- Financial information included in a tax return

.123 The proposed SSARSs include the following new requirements:

- A requirement to exercise professional judgment—which is implicit in current SSARSs.
- A requirement to obtain an engagement letter signed by both the accountant and management.

[6] The accountant may obtain one engagement letter that covers all services performed.

- A requirement to include headings in the accountant's review report.
- A requirement to name the city and state of the issuing office in the accountant's review report. The requirement may be satisfied via the letterhead.

.124 Additionally, with respect to reporting on reviewed financial statements prepared in accordance with a special purpose framework (including OCBOA frameworks), the accountant would be required to

- consider whether the financial statements are suitably titled and describe how the framework differs from GAAP.
- consider whether the financial statements include informative disclosures similar to GAAP, where appropriate.
- include an emphasis-of-matter paragraph in the accountant's review report that states that the financial statements are prepared in accordance with a special purpose framework, refers to the note that describes the framework, and states that the framework is not GAAP.
- include an other-matter paragraph that restricts the use of financial statements prepared in accordance with a contractual basis of accounting or a regulatory basis of accounting (unless intended for general use).

.125 In addition to the requirement to include an emphasis-of-matter paragraph in the accountant's review report on financial statements prepared in accordance with a special purpose framework, the proposed SSARSs will also require the inclusion of emphasis-of-matter or other-matter paragraphs in the accountant's review report in the following instances:

- When management revises financial statements for a subsequently discovered fact and the accountant's report on the revised financial statements differs from that initially issued
- When management is required to present required supplementary information
- When the accountant considers it necessary to draw users' attention to a matter

.126 The accountant will be required to communicate with management when it expects to include an emphasis-of-matter or other-matter paragraph in the accountant's review report.

ARSC Timetable for Issuance of the Clarified SSARSs

.127 The following represents the ARSC's tentative timeline with respect to issuance of the clarified SSARSs:

October 2013	The ARSC exposed for public comment the following three proposed SSARSs: • *Preparation of Financial Statements* • *Compilation Engagements* • *Association With Financial Statements*
November 5-8, 2013	ARSC to meet in Charleston, SC and consider comments received on the exposure draft of the proposed SSARSs *Review of Financial Statements* and *Review of Financial Statements—Special Considerations* and consider the following draft SSARSs: • *Framework for Performing and Reporting on Compilation and Review Engagements* • *Compilation of Pro Forma Financial Information* • *Compilation of Prospective Financial Information* The ARSC will consider voting the proposed SSARSs *Framework for Performing and Reporting on Compilation and Review Engagements* and *Compilation of Pro Forma Financial Information* for public comment.
May 2, 2014	The comment date ends with respect to the following proposed SSARSs: • *Preparation of Financial Statements* • *Compilation Engagements* • *Association With Financial Statements* • *Framework for Performing and Reporting on Compilation and Review Engagements* • *Compilation of Pro Forma Financial Information*
May 6-8, 2014	ARSC to meet in Baltimore, MD and consider comments received on the five proposed SSARSs for which comments were due May 2, 2014.
August 2014 (specific dates to be determined)	ARSC to meet (location to be determined) and consider drafts of the following proposed SSARSs and consider voting to issue as final clarified SSARSs: • *Framework for Performing and Reporting on Compilation and Review Engagements* • *Association With Financial Statements* • *Preparation of Financial Statements* • *Compilation Engagements* • *Compilation of Pro Forma Financial Information* • *Review of Financial Statements*

All proposed SSARSs are expected to be effective for calendar 2015 engagements and early implementation is expected to be permitted.

Resource Central

.128 The following are various resources that practitioners performing compilation and review engagements may find beneficial.

Publications

.129 Practitioners may find the following publications useful. Choose the format best for you—online, eBook, or print.

- *Codification of Statements on Standards for Accounting and Review Services* (product no. ACODSSARS13P [paperback] or ACODSSARS13E [eBook])
- AICPA Guide *Compilation and Review Engagements* (2013) (product no. AAGCRV13P [paperback], WRC-XX [online], or AAGCRV13E [eBook])
- AICPA Practice Aid *Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements* (product no. APACTB12P [paperback], APACTBO [online], or APACTB12E [eBook])
- AICPA Alert *Independence and Ethics Developments—2012/13* (product no. ARAIET12P [paperback], WIA-XX [online], or ARAIET12E [eBook])
- Compilation and Review Set (product no. WSR-XX [online])
- *U.S. GAAP Financial Statements—Best Practices in Presentation and Disclosure* (formerly, *Accounting Trends & Techniques*) (product no. ATTATT13P [paperback] or WNG-XX [online])
- *IFRS Financial Statements—Best Practices in Presentation and Disclosure 2012/2013* (product no. ATTIFRS12P [paperback] or WIF-XX [online])
- *Financial Reporting Framework for Small- and Medium-Sized Entities With Implementation Resources* (product no. AFRFSME13P [paperback], AFRFSME13E [eBook], or AFRFSMEO [online])

Continuing Professional Education

.130 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 736189 [text] or 187197 [DVD with manual]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control: Essentials for Financial Managers, Accountants, & Auditors* (product no. 731905 [text]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 745941 [text]). Understanding the differences between International Financial Reporting Standards (IFRSs) and GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRS and GAAP.
- *IFRS Essentials with GAAP Comparison: Building a Solid Foundation* (product no. 741605 [text]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.

.131 Among the many courses, the following are specifically related to compilation and review engagements:

- *Accounting Services, Compilations and Reviews: Effective Risk Management* (product no. 732827 [text])
- *Auditor/Accountant Communications* (product no. 733744 [text])
- *Compilation, Review, and Accounting Services* (product no. 733485 [text])

- *Performing Compilation and Review Engagements* (product no. 154700 [online] and 739700HS [CD-ROM])
- *Performing Analytical Procedures in a Review Engagement* (product no. 154710 [online])
- *Performing Inquiries in a Review Engagement* (product no. 154720 [online])
- *Introduction to Compilations and Reviews* (product no. 154730 [online])
- *Performing a Compilation Engagement Under SSARS 19* (product no. 154740 [online])
- *How to Perform a Review Under SSARS No. 19, Case Study Part I—Design and Performance of Review Procedures* (product no. 154310 [online])
- *How to Perform a Review Under SSARS No. 19, Case Study Part II—Reporting and Other Communication Requirements* (product no. 154320 [online])
- *Advanced Compilation and Review Issues* (product no. 733386 [text])
- *Compilation and Review Engagement Essentials* (product no. 733883 [text])
- *Compilation Review Update—Compilation, Review, and Accounting Service Update* (product no. 733376 [text])
- *Compilation Engagements: Mastering the Fundamentals* (product no. 733627 [text])
- *Review Engagements: Mastering the Fundamentals* (product no. 733547 [text])
- *InSight: SSARS 19—The New Compilation and Review Standard* (product no. 154230LC [online])
- *Alternatives to GAAP: Using Special Purpose Frameworks* (product no. 734093 [text])

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.132 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to those performing compilation and review engagements include the following:

- *Audit, Review & Compilation Reports*
- *Audit, Review & Compilation Reports: Engagement Reports*
- *Audit, Review & Compilation Reports: Managing Representation Letters*
- *Audit, Review & Compilation Reports: Practice Issues*
- *Audit, Review & Compilation Reports: Evaluating/Communicating Control Deficiencies*
- *Compilations and Reviews: Engagement Planning and Administration*
- *Compilation Engagements: Reporting*
- *Compilation Review Update: Current and Future Practice, Accounting, and Reporting Issues*
- *Compilations and Reviews: Independence Considerations*
- *Compilation Engagements: Introduction, Performing a Compilation and Other Compilation Engagements*
- *Compilations and Reviews: Introduction and Background*
- *Compilations and Reviews: 'Performing Compilation Engagements' plus 'Quality Control'*
- *Special Purpose Frameworks: Audit, Compilation, & Review; Procedures; AICPA's–FRF for SMEs*™ Framework
- *Review Engagements: Introduction plus Inquiry and Analytical Review Procedures*
- *Managing Compilation, Review, and Accounting Services*

To register or learn more, visit www.cpa2biz.com.

Webcasts

.133 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.134 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at 888.777.7077.

Hotlines

Accounting and Auditing Technical Hotline

.135 Do you have a complex technical question about review, compilation, accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. Eastern on weekdays. You can reach the Technical Hotline at 877.242.7212, by e-mail at aahotline@aicpa.org, or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.136 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

AICPA Online Professional Library—Accounting and Auditing Literature

.137 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. You can also sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Financial Reporting Center of AICPA.org

.138 CPAs face unprecedented challenges in financial reporting. As such, the AICPA has created the Financial Reporting Center to support the execution of high quality financial reporting. This center provides exclusive member-only resources for the entire financial reporting process and can be accessed at www.aicpa.org/frc.

.139 The Financial Reporting Center provides timely and relevant news, guidance, and examples supporting the financial reporting process, including accounting; preparing financial statements and performing compilation and reviews, audit and attest, and assurance and advisory engagements.

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Appendix A — Illustrative Analytical Procedures for Review Engagements

> ***Note***: The following examples were reprinted from the AICPA Guide *Compilation and Review Engagements*, available from www.cpa2biz.com.

Example 1 — Expected Increase in Revenue

The accountant is engaged to review the financial statements of a company that manufactures components that are utilized by other companies in customizing video gaming equipment. Because of recent legislation in several states that legalized slot machine gambling, the accountant reasonably expects sales to increase. Using his or her knowledge of the client, the client's business, and the industry in which the client operates, the accountant expects a 10 percent to 15 percent increase in sales. Further, the accountant concludes that receivables should increase and that loans payable and interest expense also would increase because the client would need to borrow money to fund the additional production.

Sample documentation

Teemickmag Gaming Company

Analytical Procedures

For the year ended December 31, 20XX

Expectations

The following are factors that should affect the relationship between current and prior year amounts:

- Increase in demand for video gaming equipment due to recent legislation in several states that legalized slot machine gambling should result in an increase in sales. Expected increase is between 10 percent and 15 percent. The accountant expects a similar increase in accounts receivable.
- Because of an increase in production of video gaming equipment, the company had to borrow additional funds. Therefore, expected increase in loans payable and interest expense is between 10 percent and 15 percent.
- No significant change in either days sales in inventory or inventory turnover is expected. Although a build-up in inventory is expected, that build-up is not expected to correspond with the increase in sales because the video gaming equipment is expected to be sold near the date of completion. Any change greater than 5 percent will be subjected to additional inquiries.

Balance sheets and income statements are available for the current year and the two years prior to the current year.

	Trend Analysis			
	Current Year	*Prior Year*	*Change*	*% Change*
Sales	$2,500,000	$2,175,000	$325.000	14.94%
Cost of goods sold	1,780,000	1,566,000	214,000	13.67%
Gross margin	720,000	609,000		
Gross margin as a % of sales	28.80%	28.00%		
Selling expenses	230,000	184,000	46,000	25.00%
Interest expense	48,000	42,000	6,000	14.29%

	Balance Sheet Ratio Analysis		
	Current Year	*Prior Year*	*Two Years Prior*
Accounts receivable, net	$1,100,000	$843,000	$703,000
Inventory	1,000,000	832,000	694,000
Loans payable	498,000	437,000	418,000

Days sales in receivables

Days sales in receivables = Accounts receivable, net at end of period ÷ (Net sales ÷ 365)

Current year days sales in receivables = $1,100,000 ÷ ($2,500,000 ÷ 365) = 161 days

Prior year days sales in receivables = $843,000 ÷ ($2,175,000 ÷ 365) = 141 days

The increase of 20 days sales in receivables (161 days – 141 days) represents a 14 percent increase. Because this increase is within the expected range, no further inquiry is necessary.

Days sales in inventory

Days sales in inventory = Inventory at the end of period ÷ (Total cost of goods sold ÷ 365)

Current year days sales in inventory = $1,000,000 ÷ ($1,780,000 ÷ 365) = 205 days

Prior year days sales in inventory = $832,000 ÷ ($1,566,000 ÷ 365) = 194 days

The increase of 11 days sales in inventory (205 days – 194 days) represents a 6 percent increase. Because this increase is greater than expected, the accountant should inquire of the client and document the reason for the unexpected increase.

Inventory turnover

Inventory turnover = Cost of goods sold ÷ Average inventory

Current year inventory turnover = $1,780,000 ÷ (($1,100,000 + 832,000) ÷ 2) = 1.84 times

Prior year inventory turnover = $1,566,000 ÷ (($832,000 + 694,000) ÷ 2) = 2.05 times

The inventory turnover decreased 10 percent; therefore, because this decrease is greater than expected, the accountant should inquire of the client and document the reason for the unexpected decrease.

The preceding documentation would be adequate. Further, after performing the trend analysis, the accountant concludes that sales, costs of goods sold, and interest expense are all reasonable, given the expectations associated with these amounts. In addition, with respect to balance sheet accounts, the increase in loans payable also is reasonable (14 percent increase) when considered with the corresponding increase in interest expense and the expectation associated with the loan payable account; however, because selling expenses increased by 25 percent, the accountant should inquire of the client and document the reason for that unexpected increase (actual increase does not correspond to expected increase).

Example 2 — Expected Decrease in Revenue

The accountant is engaged to review the financial statements of a client that owns and manages a shopping mall. Due to a poor economy, the mall lost tenants during the year; as such, the accountant reasonably expects revenue to decrease. Using his or her knowledge of the client, the client's business, and the industry in which the client operates, the accountant expects a 5 percent to 10 percent decrease in revenue during the year. Further, the accountant expects that general and administrative expenses should increase due to an increase in leasing and sales expenses and that management fees should decrease due to a decrease in tenants in the building.

Sample documentation

Pearl River Mall

Analytical Procedures

For the year ended December 31, 20XX

Expectations

The following are factors that should affect the relationship between current and prior year amounts:

- Loss of tenants due to poor economy should result in a decrease in revenue. Expected decrease is between 5 percent and 10 percent.
- Because of the increased number of vacancies, general and administrative expenses are expected to increase because of an increase in leasing and sales expenses. Expected increase is between 5 percent and 10 percent (corresponds with the decrease in revenue).
- Because of the decrease in the number of tenants in the building, management fees are expected to decrease between 5 percent and 10 percent (corresponds with decrease in revenue).

Balance sheets and income statements are available for the current year and the two years prior to the current year.

	Trend Analysis			
	Current Year	*Prior Year*	*Change*	*% Change*
Total revenue	$7,223,000	$8,603,000	$(1,380,000)	(16.04)%
Costs and expenses: management fees	339,000	387,000	(48,000)	(12.40)%
General and administrative	583,000	511,000	72,000	14.09%

Similar balance sheet analytics should be performed as those performed in the preceding example 1.

The preceding documentation would be adequate; however, the results of the analytical procedures do not agree with the documented expectations associated with those procedures. Therefore, the accountant should inquire and document why the decrease in tenant revenue, the decrease in management fees, and the increase in general and administrative expenses exceeded expectations.

Example 3 — No Significant Change in Revenue or Expenses Expected

The accountant is engaged to review the financial statements of a small, privately held client in the candy store business. The accountant has performed a review of the financial statements of the candy store for each of the past five years with no significant change in revenue or expenses in any of those years. The accountant expects that trend to continue.

Sample documentation

Mom and Pop Candy Store

Analytical Procedures

For the year ended December 31, 20XX

Expectations

- Based on discussions with the owner-manager, no significant changes from prior year amounts are expected.
- All increases and decreases greater than 5 percent will be subjected to additional inquiries.

	Trend Analysis			
	Current Year	*Prior Year*	*Change*	*% Change*
Sales	$44,000	$39,000	$5,000	12.82%
Cost of goods sold	32,500	31,000	1,500	4.84%
Gross margin	11,500	8,000		
Gross margin as a % of sales	26.14%	20.51%		
Operating expenses	5,200	4,500	700	15.56%
Net income	6,300	3,500		

Similar balance sheet analytics should be performed as those performed in the preceding example 1.

The preceding documentation would be adequate; however, the results of the analytical procedures do not agree with the documented expectations associated with those procedures. Therefore, the accountant may deem it appropriate to inquire and document why sales increased by an amount greater than expected. In addition, the accountant should inquire about why there was not a comparable increase in cost of goods sold. Also, the accountant should discuss with the owner-manager why there is a greater than expected increase in operating expenses and document the results of the discussion.

Example 4 — Expected Changes in Construction Contracts

The accountant is engaged to review the financial statements of a general construction contractor primarily engaged in the construction of commercial office buildings. The accountant has performed the review of this company's financial statements for several years and expects that the current project in process should yield a 5 percent gross profit margin, consistent with similar projects in the past and in accordance with the initial project estimate.

Sample documentation

ABC Construction Contractors

Analytical Procedures

For the Year Ended December 31, 20XX

Expectations

- Based upon discussions with the project manager, it is believed that the gross margin will be consistent with the 5 percent margin achieved in the past and in accordance with the initial project estimate.
- Any deviation in the margin greater than 1 percent will be subjected to additional inquiries.

	Trend Analysis			
Building Contract	*Current Year*	*Prior Year*	*$ Change*	*% Change*
Contract value	$5,000,000	$5,000,000		
Estimated costs at completion	4,900,000	4,750,000	$150,000	3.15%
Planned profit	100,000	250,000	150,000	60.00%
Costs incurred	2,500,000	1,000,000		
Profit recognized contract to date	50,000	50,000		

The preceding documentation indicates that the profit margin on the contract has slipped from 5 percent to 2 percent. Additionally, in accordance with the cost-to-cost method of percentage of completion accounting, it now appears that all of the contract profit was recognized in year one. This may indicate a potential error in the original estimate or a project that is quickly running over budget. The result may be a reversal of profits recognized in earlier periods under the percentage of completion method of contract revenue recognition or a potential loss contract. Further inquiry of management should be considered to discuss potential project issues that will negatively affect profit recognition in the financial statements.

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Appendix B — Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants who perform compilation and review engagements, as well as management of entities for whom such engagements are performed.

Website Name	*Content*	*Website*
AICPA	Summaries of professional standards as well as other AICPA activities.	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations.	www.aicpa.org/Research/Standards/CompilationReview/ARSC/Pages/ARSC.aspx
AICPA Financial Reporting Center	Summaries of AICPA standard setting activity, recently issued technical Q&As, and financial reporting news. Links to other information related to accounting and financial reporting, audit and attest services, compilation services, review services, and assurance and advisory services.	www.aicpa.org/frc
AICPA Financial Reporting Executive Committee	AICPA technical committee for financial reporting. Its mission is to determine the AICPA's technical policies regarding financial reporting standards and to be the AICPA's spokesbody on those matters, with the ultimate purpose of serving the public interest by improving financial reporting.	www.aicpa.org/InterestAreas/frc/AccountingFinancialReporting/Pages/FinREC.aspx
AICPA Professional Ethics Executive Committee	AICPA technical committee charged with the responsibility of interpreting and enforcing the AICPA Code of Professional Conduct.	www.aicpa.org/InterestAreas/ProfessionalEthics/Pages/Professional Ethics.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies.	www.economy.com
The Federal Reserve Board	Source of key interest rates.	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities.	www.fasb.org
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules.	www.gao.gov

Website Name	*Content*	*Website*
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities.	www.gasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards.	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Compilation and Review Standards.	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena.	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting.	www.pcfr.org
USA.gov	Portal through which all government agencies can be accessed.	www.usa.gov

[*The next page is 8987.*]

AAM Section 8240

Independence and Ethics Developments—2014/15

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This alert replaces AICPA Alert *Independence and Ethics Developments—2012/13.*

Recognition

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Feedback

Any comments you have about the alert would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This alert informs you of recent developments in the important areas of independence and ethics for accountants—an area that continues to receive increased attention from regulators, investors, analysts, the news media, and others. This alert helps you understand your professional responsibilities under the AICPA Code of Professional Conduct (the code) and, as applicable, other rule-making and standard-setting bodies.

Current Practice Environment

.02 The practice environment continues to be one where regulators, users of financial statements, the business community, and the profession itself have placed increasing emphasis on ethics and independence. Though the SEC and the PCAOB have not issued any specific independence rule changes or guidance in the last few years, they have nonetheless had auditor independence and objectivity clearly in their sights.

.03 At the international level, securities regulators, including the SEC, are exchanging ideas on ethics and independence topics through the International Organization of Securities Commissioners. In addition, the International Federation of Accountants (IFAC) through its ethics and independence standards setting body—the International Ethics Standards Board for Accountants (IESBA)—continues to enhance its code. The AICPA participates in the IESBA standard-setting process through its representative on the IESBA and the Professional Ethics Executive Committee (PEEC) closely monitors all standard-setting projects and comments on all IESBA proposals. In such capacity, the AICPA is able to stay abreast of international ethics standard-setting activities, provide thought leadership, and when appropriate, lead convergence projects that are believed to benefit the U.S. accounting profession.

New and Revised AICPA Ethics and Independence Requirements

AICPA Ethics Codification Project—The Revised Code

.04 At its January 2014 meeting, the PEEC adopted its final version of the revised AICPA Code of Professional Conduct. This project, which commenced in November 2008, was one of the longest in the PEEC's recent history, spanning more than six years and consuming a significant amount of resources. The result however is something that AICPA members will find to be extremely useful. PEEC restructured and codified the code so that members and other users of the code can apply the rules and reach appropriate conclusions more easily and intuitively. This effort is referred to as the *AICPA Ethics Codification Project*.

.05 Similar to the recent FASB Codification Project and the Auditing Standards Board's Clarity Project, the goals of the Ethics Codification Project were to reorganize and reformat the code into a structure that is easier for members and others to use, and will also allow them to reach correct conclusions more quickly and intuitively. In addition, in order to enhance the user's understanding of the code's requirements, the PEEC decided to link certain nonauthoritative information issued by the AICPA Professional Ethics Division to the related topic in the code.

.06 While the intent of the project was not specifically to revise the code, a substantial amount of the code's content was redrafted using consistent drafting and style conventions in order to clarify the existing guidance as part of the reformatting process. In some cases, the PEEC concluded that the existing guidance should be expanded to make it broader or more understandable. Consequently, some changes to prior guidance were identified in the PEEC exposure draft as substantive changes. These revisions are also specifically noted in the revised code. One of the PEEC's intentional changes was the redrafting of all preexisting ethics rulings as ethics interpretations. Such rulings had historically been drafted in a question and answer format, which typically covered a very narrow and specific set of facts and usually focused on one particular issue. In the revised code, all rulings were redrafted as interpretations and are now codified under their appropriate topics. Furthermore, these new interpretations (or revised rulings) have often been broadened in scope, and thus, will likely be more informative to members. Additionally, the revised code distinguishes rules from interpretations. The following are examples:

- Rule 101, *Independence* [ET sec. 101.01] is referred to as the "Independence Rule" [ET sec. 1.200.001] in the revised code.
- The content from the ethics ruling entitled "Financial Services Company Client Has Custody of a Member's Assets" [ET sec. 191.081–.082] is incorporated into the "Brokerage and Other Accounts"

interpretation [ET sec. 1.255.020] found under the subtopic "Depository, Brokerage, and Other Accounts" [ET sec. 1.255] of the "Independence" topic [ET sec. 1.200].

> **NOTE:** In this alert, referenced rules and interpretations found in both the current code and the version that becomes effective December 15, 2014, will be presented with citations for both versions as follows: "ET sec. XXX; as of December 15, 2014, ET sec. X.XXX." All ET section references are from AICPA, *Professional Standards*.

.07 The most significant change brought about by the Ethics Codification Project is the incorporation of two new conceptual frameworks, which are discussed in a separate section.

.08 The reformatted code is organized in a manner that allows users to quickly find those requirements that apply to them. It now has four sections, organized by type of user:

- Preface—Provides general information about the code and its structure, contains the broad principles of professional conduct and definitions, and has new guidance on changes to the code and the related effective dates. This section is applicable to all users.
- Part 1: "Members in Public Practice"—Contains all guidance applicable to members in public practice.
- Part 2: "Members in Business"—Contains all guidance applicable to members in business.
- Part 3: "Other Members"—Contains all guidance applicable to all other members, such as individuals who are retired or not currently in the workforce.

.09 Similar to the other recent codifications projects mentioned previously, parts 1, 2, and 3 each use an organizational structure that starts with *topics*, which are then typically broken down by *subtopic*, which are then broken down by *sections*, with each subsequent level providing more specific information to the user. After this material, any nonauthoritative information that is applicable to the topic, subtopic, or section is shown in boxed text at the end of the applicable standard. The reformatted code uses a numerical hierarchy similar to that of the FASB *Accounting Standards Codification*® (ASC), which allows a user to easily locate relevant information. The AICPA's Professional Ethics Division staff has developed a mapping document that will assist members' understanding of where to find various matters in the revised code by showing cross references to the current code.[1] This mapping document will also be reproduced in the code for a period.

.10 The effective date of the revised code is December 15, 2014; however, the effective date of the new conceptual frameworks is one year later—December 15, 2015. Members are permitted to implement both the revised code and the conceptual frameworks prior to their effective dates; however, the PEEC decided that members should not implement the relevant conceptual framework prior to implementing the revised code. The revised code will be issued in its electronic format and will be free of charge to all users. It is located at pub.aicpa.org/codeofconduct.

.11 As noted previously, one of the major reasons for undertaking the project was to make the code easier for members to understand and use. Even though that goal has been accomplished, transitioning to the revised code will present some challenges to members. Because the layout and format of the revised code is so different from what members are used to, there will be a learning curve for even the most experienced members. Therefore, members should take steps to become familiar with and test their use of the code prior to the effective dates. It may be advantageous to attend a seminar or take a continuing professional education (CPE) course to enhance your understanding of the code and the conceptual frameworks. Because members in business have not yet had to apply the threats and safeguards approach utilized in the conceptual frameworks, it will be very important for these members to begin to learn how to understand and use the revised code as soon as possible. Please see the "Resource Central" section of this publication for more information on transitioning to the revised code.

[1] www.aicpa.org/InterestAreas/ProfessionalEthics/Community/Pages/ethics-codification-implementation-tools.aspx.

Changes to the Conceptual Framework

.12 Since 2006, the Code of Professional Conduct has included a "Conceptual Framework for AICPA Independence Standards,"[2] which is used by members when considering independence matters that are not specifically addressed in the code. Please note that the existing conceptual framework should be used only for independence related matters and it does not apply to other parts of the code. The existing conceptual framework was based on the risk-based approach that the PEEC and other standard setters typically apply in developing independence standards. The risk-based approach entails evaluating the risk that the member would not be independent, or that the member would be perceived as not independent by a reasonable and informed third party with knowledge of all relevant information. It requires the following three steps:

1. Identify and evaluate potential threats to independence and determine whether those threats are at an acceptable level.

2. Where such threats are not at an acceptable level, the member must consider and apply appropriate safeguards to eliminate the threats or reduce them to an acceptable level.

3. If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

.13 The existing conceptual framework describes and defines seven threats to independence:

- **Self-review threat.** Members reviewing as part of an attest engagement evidence that results from their own or their firm's nonattest work such as, preparing source documents used to generate the client's financial statements.

- **Advocacy threat.** Actions promoting an attest client's interests or position such as promoting the client's securities as part of an initial public offering or representing a client in U.S. tax court.

- **Adverse interest threat.** Actions or interests between the member and the client that are in opposition, such as, commencing, or the expressed intention to commence, litigation by either the client or the member against the other.

- **Familiarity threat.** Members having a close or longstanding relationship with an attest client or knowing individuals or entities (including by reputation) who performed nonattest services for the client, such as a member who performs insufficient audit procedures when reviewing the results of a nonattest service because the service was performed by the member's firm, or a member of the attest engagement team whose close friend is in a key position at the client

- **Undue influence threat.** Attempts by an attest client's management or other interested parties to coerce the member or exercise excessive influence over the member, such as a client's threat to replace the member or the member's firm over a disagreement with client management on the application of an accounting principle, or pressure from the client to reduce necessary audit procedures for the purpose of reducing audit fees

- **Financial self-interest threat.** Potential benefit to a member from a financial interest in, or from some other financial relationship with, an attest client, such as excessive reliance on revenue from a single attest client, or having a material joint venture or other material joint business arrangement with the client

- **Management participation threat.** Taking on the role of client management or otherwise performing management functions on behalf of an attest client, such as establishing and maintaining internal controls for the client, or hiring, supervising, or terminating the client's employees.

.14 The existing conceptual framework defines *safeguards* as "controls that eliminate or reduce threats to independence," and it includes a discussion on the effectiveness of safeguards, as well as an expansive (but not all-inclusive) listing of safeguards that the member may consider applying in the circumstances.

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[2] ET section 100-1; as of December 15, 2014, ET section 0.400.01.

.15 In connection with the Ethics Codification Project discussed above, the PEEC decided that it would be helpful if the code contained guidance on how to address relationships or circumstances that are not addressed in the code but that give rise to threats to rules other than independence. As a result, the PEEC developed two new conceptual frameworks, one for members in business, and another for members in public practice. Both of the new conceptual frameworks are to be used only in situations for which the revised code does not contain a specific rule or requirement; however, failure of a member to apply the conceptual framework in those circumstances will be considered a failure of the member to comply with the code.

.16 The PEEC used an existing nonauthoritative document, the *Guide for Complying With Rules 102–505* (the guide), and the existing "Conceptual Framework for AICPA Independence Standards" as starting points when developing these conceptual frameworks for the revised code:

- "Conceptual Framework for Members in Public Practice"[3]
- "Conceptual Framework for Members in Business"[4]

.17 The guide outlines a threats and safeguard approach that members can use when evaluating relationships or circumstances that could cause a member to violate the following rules:

- *Integrity and Objectivity* (Rule 102)
- *General Standards* (Rule 201)
- *Compliance With Standards* (Rule 202)
- *Accounting Principles* (Rule 203)
- *Confidential Client Information* (Rule 301)
- *Contingent Fees* (Rule 302)
- *Acts Discreditable* (Rule 501)
- *Advertising and Other Forms of Solicitation* (Rule 502)
- *Commissions and Referral Fees* (Rule 503)
- *Form of Organization and Name* (Rule 505)

.18 The new "Conceptual Framework for Members in Business" contains six threats as opposed to the seven threats outlined in "Conceptual Framework for Members in Public Practice" because the PEEC determined that the management participation threat would not be relevant to members in business for obvious reasons. The new frameworks describe and define those six threats to compliance with the ethics rules, as follows:

- **Adverse interest threat.** The threat that a member will not act with objectivity because the member's interests are opposed to the interests of the employing organization.
- **Advocacy threat.** The threat that a member will promote an employing organization's interests or position to the point that his or her objectivity is compromised.
- **Familiarity threat.** The threat that, due to a long or close relationship with a person or an employing organization, a member will become too sympathetic to their interests or too accepting of the person's work or employing organization's product or service.
- **Self-interest threat.** The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, the employing organization or persons associated with the employing organization.
- **Self-review threat.** The threat that a member will not evaluate the results of a previous judgment made or service performed or supervised by the member, or an individual in the employing

[3] ET sec. 1.000.010.

[4] ET sec. 2.000.010.

organization, and that the member will rely on that service in forming a judgment as part of another service.

- **Undue influence threat.** The threat that a member will subordinate judgment to that of an individual associated with the employing organization or any relevant third party due to that individual's position, reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member.

.19 Once again, a risk-based approach entails evaluating the risk that the member would not be in compliance with the rules, or would be perceived by a reasonable and informed third party having knowledge of all relevant information as not being in compliance with the rules. The process of applying the new "Conceptual Framework for Members in Business" is the same that is described previously in the three-step process used for independence matters. The member should work through the following steps:

1. Identify and evaluate potential threats to compliance with respect to the relevant rule (*Integrity and Objectivity*, for example) which result from a specific relationship or circumstance and determine whether those threats are at an acceptable level.

2. Where such threats are not at an acceptable level, the member must consider and apply appropriate safeguards to eliminate the threats or reduce them to an acceptable level.

3. If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, the rule will be violated, and the member should decline or discontinue the professional services, or resign from the engagement, or in the case of a member in business, resign from the employing organization.

.20 The PEEC has recognized that using the conceptual frameworks may be unfamiliar to many members, especially those in business who may never have had to use the threats and safeguards approach before. As a result, members have been given an additional year before they will be required to implement the new conceptual frameworks. Furthermore, the AICPA is developing a conceptual frameworks toolkit that will assist members in understanding and applying the conceptual framework concepts to their specific situations. The toolkit is expected to contain checklists, flowcharts, case summaries, and frequently asked questions. It will include examples and materials relevant to members both in public practice and in business. The toolkit is expected to be available in 2015. Check the Ethics Codification Project page for updates at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/Pages/aicpa-ethics-codification-project.aspx.

New Definition—"Partner Equivalent" Under ET Section 92, *Definitions*

.21 In March 2013, the PEEC adopted a new definition of "partner equivalent" that will be effective for engagements covering periods beginning on or after December 15, 2014. The new definition extends to partner equivalents the independence requirements that are applicable to partners. It was adopted because the PEEC believed that certain individuals who did not meet the definition of partner[5] of a firm (as defined in the code) may have duties, responsibilities or powers with respect to attest engagements that effectively permit them to act as a partner while not legally being a partner.

.22 Under the new definition, a *partner equivalent* is a professional employee who is not a partner of the firm but who either

a. has the authority to bind the firm to conduct an attest engagement without a partner's approval (for example, the professional employee has the authority to sign or to affix the firm's name to an attest engagement letter or contract to conduct an attest engagement without partner approval), or

b. has the ultimate responsibility for the conduct of an attest engagement, including the authority to sign or affix the firm's name to an attest report or issue, or authorize others to issue, an attest report on behalf of the firm without partner approval.

[5] The Code of Professional Conduct defines a *partner* as "a proprietor, shareholder, equity or nonequity partner or any individual who assumes the risks and benefits of firm ownership or is otherwise held out by the firm to be the equivalent of any of the aforementioned.

.23 In adopting the definition, the PEEC indicated its belief that having the authority to bind the firm to a professional service engagement is a partner level responsibility and therefore individuals having such authority are equivalent to partners. The PEEC made a distinction between individuals having partner level powers for attestation engagements versus those who may have such powers with respect to other types of engagements (for example, tax or consulting) because they believed that the risks associated with such engagements were higher.

.24 Members in public practice should consider whether they or other individuals in their firms meet the above definition, and if so, ensure that those individuals are compliant with all AICPA independence requirements that apply to a partner of the firm.

Revisions to Interpretation No. 101-3—Nonattest Services

Cumulative Effect on Independence When Providing Nonattest Services

.25 The "Nonattest Services" interpretation[6] has provided guidance for many years now to members in public practice concerning the performance of certain services that could be considered to impair independence. It has also been revised numerous times to address new or changing practice issues. Though the guidance in this interpretation has focused on various types of engagements and activities, it has not contained any requirements or specific guidance on the effect that multiple nonattest engagements might have on independence.

.26 In August 2013, the PEEC approved a significant change to the interpretation that will now require a member in public practice to consider the cumulative effect on independence that arises from a member, or a member's firm, performing multiple permitted nonattest services or engagements. The new requirement is effective for engagements covering periods beginning on or after December 15, 2014.

.27 The PEEC has determined that performing multiple nonattest services can increase the significance of the self-review and the management participation threats, as well as other threats to independence. Under the new requirements, it is not sufficient for a member to consider only the threats to independence at the time an engagement to perform a nonattest service begins. Rather, a member is now required to evaluate whether the performance of multiple nonattest services in the aggregate creates a significant threat to the member's independence that cannot be reduced to an acceptable level by the application of the safeguards outlined in the interpretation's general requirements section. In cases where threats are not at an acceptable level, the interpretation requires the member to apply additional safeguards to eliminate the threats, or reduce them to an acceptable level. If the threats cannot be eliminated or reduced to an acceptable level, the member's independence will be impaired.

.28 Under the new guidance, a member is not required to consider the possible independence threats created by any nonattest services that are provided to the member's attest client by other network firms within the member's firm's network.

Certain Services Performed in Connection With an Attest Engagement

.29 The AICPA's Professional Ethics Division has noted for several years now that there has been confusion among members in public practice concerning services that are typically performed in conjunction with an attest engagement, such as preparation of financial statements, cash to accrual conversions, reconciliations, and similar activities. Many members viewed these services as part of the attest engagement because they were often enumerated in the audit, review, or compilation engagement letter. More specifically, members were seeking clarity regarding whether such services are simply a part of the attest engagement or whether they are actually a separate engagement that would be subject to the general requirements of the "Nonattest Services" interpretation.

[6] ET sec. 101 par. .05; as of December 15, 2014, ET sec. 1.295.

.30 PEEC recently clarified these situations and added guidance to the "Nonattest Services" interpretation in the "Activities Related to Attest Services"[7] section as follows:

> "...activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of the attest engagement and, therefore, constitute a nonattest service. Such activities would not impair independence provided the requirements of this interpretation are met."

.31 The requirements referenced in the PEEC revision in paragraph .30 are those in the "General Requirements for Performing Nonattest Services" section of the interpretation. These requirements include determining that the client has assumed all management responsibilities (and the member has not assumed any such responsibilities), determining that the client properly oversees the service, determining that the client evaluates the adequacy and results of the service, and determining that the client accepts responsibility for the service. These matters are often outlined specifically in an engagement letter, which may also cover the attest engagement.

.32 The requirement to treat the above services, as well as any other services of a similar nature, as nonattest services is effective for engagements covering periods beginning on or after December 15, 2014.

Revisions to Interpretation No. 102-4—Subordination of Judgment by a Member

.33 At its May 2013 meeting, the PEEC approved significant revisions to the "Subordination of Judgment by a Member" interpretation,[8] which became effective on August 31, 2013. Before the revisions, this interpretation, which requires that the member take specific steps to ensure that a situation does not constitute a subordination of judgment, had only one example involving circumstances in which a member and the member's supervisor have a disagreement or dispute relating to the preparation of financial statements or the recording of transactions. The PEEC believed that the example was too narrow and that it applied primarily to members in business. The PEEC therefore decided to clarify that the interpretation applies to all members, and to broaden it to cover differences of opinion with a supervisor related to the application of accounting principles, auditing standards, or other relevant professional standards, including standards applicable to tax and consulting services, or applicable laws or regulations. In addition, the PEEC has clarified that the guidance applies when performing professional services for a client, an employer, or on a volunteer basis.

.34 In making its revisions, the PEEC took a threats-and-safeguards approach because it believed that such differences of opinion could result in self-interest, familiarity, and undue influence threats to the member's compliance with the *Integrity and Objectivity* rule.

.35 The key revisions are as follows:

- The interpretation clarifies that the guidance is addressing internal firm and company disagreements and not differences of opinion between a member and client.
- Requires members to assess any identified threats and form a conclusion about whether the result of the position taken by the supervisor fails to comply with professional standards, when applicable; creates a material misrepresentation of facts; or may violate applicable laws or regulations.
- In circumstances whereby the member concludes that the position taken by the supervisor results in a material misrepresentation of facts or a violation of applicable laws or regulations, then threats to the member's compliance with the *Integrity and Objectivity* rule would be considered significant. In such circumstances, the member should discuss his or her concerns with the supervisor, and if the difference of opinion is not resolved with the supervisor, the member should discuss his or her concerns with the appropriate higher level(s) of management within the organization.
- In circumstances whereby the member concludes that appropriate action has not been taken by the supervisor or appropriate higher level(s) of management within the organization, the member should

[7] ET sec. 101 par. .05; as of December 15, 2014, ET sec. 1.295.010 par. .04.

[8] ET sec. 102 par. .05; as of December 15, 2014, ET sec. 1.130.020.

consider applying safeguards to eliminate or reduce the threats to an acceptable level (specific examples of safeguards for the member to consider are presented in the interpretation). If the member concludes that no safeguards can eliminate or reduce the threats to an acceptable level or if the member concludes that appropriate action was not taken, he or she should consider his or her continuing relationship with the organization and take appropriate steps to eliminate his or her exposure to subordination of judgment.

New Definition—"Those Charged With Governance" Under ET Section 92, *Definitions*

.36 The AICPA code had several references to the term "those charged with governance" even though the term was not defined. Additionally other standard setters, including the international level, are increasingly using the term and establishing requirements related to those charged with governance. In an effort to assist members in their understanding of the term, at its January 2014 meeting, the PEEC approved a new definition, "those charged with governance," which became effective on May 31, 2014.

.37 The new definition is as follows:

> **Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).
>
> When an interpretation requires communicating with those charged with governance, the member should determine, considering the nature and importance of the particular circumstances and matter to be communicated, the appropriate person(s) within the entity's governance structure with whom to communicate. If the member communicates with a subgroup of those charged with governance (for example, an audit committee or an individual), the member should determine whether communication with all of those charged with governance is also necessary, so that they are adequately informed.

Conflicts of Interest

.38 The currently effective Interpretation No. 102-2 is applicable to members both in public practice and in business. Due to the unique circumstances facing members in public practice and members in business, the PEEC felt that it would be more appropriate to have two separate interpretations in which the guidance is tailored to address conflicts of interest that might arise when providing professional services to clients (for members in public practice) and those that may arise when providing professional services for the member's employing organization (for members in business).

.39 In May 2014, the PEEC adopted a revised Interpretation No. 102-2, "Conflicts of Interest for Members in Public Practice,"[9] and new Interpretation No. 102-7, "Conflicts of Interest for Members in Business."[10] Both interpretations are based on the newly adopted guidance concerning conflicts of interest issued by the IESBA. (See the previous discussion.)

.40 Both interpretations are effective September 30, 2014.

.41 In an effort to clarify what would be considered a conflict of interest, the newly adopted interpretations contain a description of a conflict of interest and additional examples of situations that may result in a conflict of interest. The PEEC believes including the description and additional examples in the interpretations will assist members in identifying the types of relationships and interests that may give rise to a conflict of interest.

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[9] ET sec. 102 par. .03; as of December 15, 2014, ET sec. 1.110.010.

[10] ET sec. 102 par. .08; as of December 15, 2014, ET sec. 2.110.010.

.42 Similar to the IESBA requirements, the interpretations require the member to take reasonable steps to identify circumstances that might create a conflict of interest. Where a conflict of interest has been identified, the member is required to evaluate the significance of the threats created by the conflict of interest. If threats are not at an acceptable level, the member is required to apply safeguards to eliminate threats or reduce them to an acceptable level. Even for situations in which threats are considered to be at an acceptable level, members are required to disclose the conflict of interest to the client (for members in public practice) or to appropriate levels within the employing organization (for members in business) as well as any other appropriate parties, and obtain their consent to perform the professional services. The interpretations also encourage, but do not require, the member to document such disclosure and consent.

Recently Effective AICPA Ethics and Independence Requirements:

Application of the Independence Rules to Affiliates—Interpretation No. 101-18

.43 In August 2011, the PEEC approved new interpretation, "Application of the Independence Rules to Affiliates,"[11] which added an affiliates definition to the AICPA code. The PEEC gave the interpretation a significantly delayed effective date because it represented a substantial change from prior independence requirements and implementation was expected to be difficult for many members. The new requirement to apply independence requirements to certain affiliates of a financial statement attest client became effective for engagements covering periods beginning on or after January 1, 2014.

.44 This interpretation requires members to be independent of certain affiliates of a financial statement attest client (specifically, audits and reviews of financial statements and compilations of financial statements in which the member's compilation report does not disclose a lack of independence). Under the definition, the following entities are considered affiliates of a financial statement attest client:

a. An entity (for example, subsidiary, partnership, or limited liability company [LLC]) that a financial statement attest client can control.

b. An entity in which a financial statement attest client, or an entity controlled by the financial statement attest client, has a direct financial interest that gives the financial statement attest client significant influence over such entity and that is material to the financial statement attest client.

c. An entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity.

d. An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.

e. A sister entity of a financial statement attest client, if the financial statement attest client and sister entity are each material to the entity that controls both.

f. A trustee that is deemed to control a trust financial statement attest client that is not an investment company.

g. The sponsor of a single-employer employee benefit plan financial statement attest client.

h. Any union or participating employer that has significant influence over a multiple or multiemployer employee benefit plan financial statement attest client.

i. An employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client. A financial statement attest client that sponsors an employee benefit plan includes, but is not limited to, a union whose members participate in the plan and participating employers of a multiple or multiemployer plan.

[11] ET sec. 101 par. .20; as of December 15, 2014, 0.400.02.

j. An investment adviser, general partner, or trustee of an investment company financial statement attest client (fund), if the fund is material to the investment adviser general partner or trustee, and he or she is deemed to have either control or significant influence over the fund. When considering materiality, members should consider investments in, and fees received from, the fund.

.45 Members should apply the independence rules to the affiliates of their financial statement attest clients unless they meet one of four exceptions. Broadly, the exceptions relate to the following:

- Certain loans to or from an individual who is an officer, director, or 10 percent or more owner of an affiliate
- Nonattest services provided to certain affiliates that do not threaten independence with respect to the financial statement attest client under the "Conceptual Framework for AICPA Independence Standards" for example, self-review or management participation threats
- A covered member's subsequent employment with certain affiliates provided the former employee is not in a key position with respect to the financial statement attest client; and
- Employment of a covered member's close relatives or immediate family members by certain affiliates, when their position does not put them in a key position with respect to the financial statement attest client

.46 Recently, the Professional Ethics Division issued a non-authoritative staff FAQ document to help members better understand how the definitions and guidance provided in Interpretation No. 101-18, "Application of the independence rules to affiliates,"[12] apply to affiliates of employee benefit plans subject to the Employee Retirement Income Security Act.[13] Please note that the questions and answers should not be used for governmental employee benefit plan financial statement attest clients except for governmental employee benefit plans that are subject to GASB standards.

New and Revised IFAC Ethics and Independence Requirements

> **Informational Note:** IFAC is the global organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC has several standard-setting boards one of which is the IESBA. IESBA develops and issues ethical standards and other pronouncements for professional accountants worldwide. As a member body of IFAC, the AICPA (through the PEEC) has agreed to maintain ethics standards that, at a minimum, meet the IESBA ethics standards.

Breaches of the IESBA Code of Ethics for Professional Accountants

.47 At its December 2012 meeting, the IESBA approved the changes to the IESBA code addressing *Breaches of a Requirement of the Code* as a final standard, which was released in March 2013 and is effective on April 1, 2014 (early application is permitted). The amendments resulted from an exposure draft published in October 2011 and stemmed from the existing code at that time, which contained several provisions that addressed an inadvertent violation of a provision of the code indicating that such a violation would not compromise compliance with the fundamental principles, or independence, provided certain conditions are met. The IESBA decided to reconsider such provisions believing that they could be misread as implying that all inadvertent violations can be corrected by applying necessary safeguards.

.48 The revised code has new requirements relating to when a breach of an independence requirement of the code has occurred. The code now requires a firm to undertake various actions, which may include

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[12] ET sec. 101 par. .20.

[13] You can find the FAQ at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/FINAL2013August26FAQsOnApplictionOfTheIndependnceRulesToAffiliatesOfEmployeeBenefitPlans.pdf.

terminating the relationship causing the breach, evaluating the significance of the breach, communicating the breach, and documentation requirements. Among other things, the code specifies that depending on the significance of the breach, it may be necessary to terminate the audit engagement, or it may be possible to take action that satisfactorily addresses the consequences of the breach.

.49 In considering what actions may be necessary, the guidance indicates that the firm should exercise professional judgment and take into consideration whether a reasonable and informed third party, weighing the significance of the breach, the action to be taken, and all the specific facts and circumstances, would be likely to conclude that the firm's objectivity has been compromised, and therefore the firm would be unable to issue an audit report. It also provides examples of other actions the firm might consider, as follows:

- Removing the relevant individual from the audit team
- Conducting an additional review of the affected audit work or re-performing that work to the extent necessary and in either case using different personnel
- Recommending that the audit client engage another firm to review or re-perform the affected audit work to the extent necessary
- Where the breach relates to a non-assurance service that affects the accounting records or an amount that is recorded in the financial statements, engaging another firm to evaluate the results of the non-assurance service or having another firm re-perform the non-assurance service to the extent necessary to enable it to take responsibility for the service

.50 Regarding the requirements to communicate breaches, the IESBA concluded the following:

- The firm shall discuss all breaches and the action it has taken, or proposes to take, with those charged with governance. The communication shall be as soon as possible, unless those charged with governance have specified an alternative timing for less significant breaches.
- The firm shall communicate the breach in writing to those charged with governance.
- In addition to complying with any legal or regulatory requirements, the firm shall consider reporting a breach to a member body, relevant regulator, or oversight authority when such reporting is common practice or encouraged in the particular jurisdiction by the member body, regulator, or oversight authority.

Changes to the IESBA Code of Ethics for Professional Accountants Addressing Conflicts of Interest

.51 At its December 2012 meeting, the IESBA approved the changes to the IESBA code addressing conflicts of interest as a final pronouncement, which was released in March 2013 and is effective on July 1, 2014.

.52 The changes establish additional specific requirements around conflicts of interests, and provide more comprehensive guidance to support professional accountants in identifying, evaluating, and managing conflicts of interest. The requirements apply to accountants both in public practice and in business, taking into account the different circumstances in which they work.

.53 The IESBA pronouncement

- contains a description of circumstances that might create a conflict of interest;
- requires professional accountants to consider whether or not a reasonable and informed third party, weighing all the specific facts and circumstances available to the accountant at that time, would be likely to conclude that compliance with the fundamental principles is compromised; and
- contains guidance on the nature of safeguards that may be available to manage conflicts of interest.

New and Revised Ethics and Independence Requirements of the SEC and PCAOB

.54 Neither the SEC nor the PCAOB has released new rules, regulations, or guidance regarding ethics or independence matters during the past two years. However, in speeches and other more informal communications, commissioners and staff members of both organizations have continued to emphasize the importance of auditor independence and objectivity to the public markets.

.55 More information regarding these communications and the status of the PCAOB's concept release on firm rotation is located in the next section, "Trending Ethics and Independence Topics."

Trending Ethics and Independence Topics

Nonattest Services

.56 Both members in public practice and their clients (who are often members in business) need to continue to carefully monitor the changing requirements regarding nonattest services prohibitions.

.57 On the public company front, the SEC has continued to express its concerns—in speeches and otherwise—about the potential that providing certain nonaudit services to audit clients may compromise auditor independence. In recent years, the PEEC has revised the "Nonattest Services" interpretation several times in an effort to make the guidance more useful for members.

.58 For instance, the PEEC rolled out additional guidance concerning "management responsibilities" in response to concerns that members might not fully understand the types of activities encompassed within that phrase. The PEEC clarified that management responsibilities involve leading and directing an entity, including making significant decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources. If a member in public practice assumes a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce that threat to an acceptable level. For this reason, assumption of management responsibilities would impair independence. The PEEC has added helpful examples of activities that would be considered a management responsibility to the "Nonattest Services" interpretation.

.59 Another area of concern is the provision of internal audit assistance services (sometimes referred to as "internal audit outsourcing"), since the requirements have been modified in recent years. Assisting the client in performing financial and operational internal audit activities would impair independence, unless the member takes appropriate steps to be satisfied that the client accepts its responsibility for designing, implementing, and maintaining internal control and directing the internal audit function, including the management thereof.

.60 The PEEC has also made changes to the internal audit services guidance to clarify what the term *monitoring activities* means and how such activities may affect independence. The guidance indicates that monitoring activities can be performed through either ongoing evaluations, or separate evaluations, or some combination of the two. To help clarify the differences between ongoing and separate evaluations, descriptions of both have been incorporated into the "Nonattest Services" interpretation and the descriptions align with COSO's internal control framework.[14]

.61 The revised independence guidance indicates that separate evaluations generally do not create a significant threat independently, whereas ongoing evaluations create a significant management participation threat that would impair independence. The revised guidance also requires that members use judgment in determining whether otherwise permitted internal audit services that are normally permitted may result in a significant management participation threat. Members can make this determination by considering other

[14] Issued by COSO (Committee of Sponsoring Organizations of the Treadway Commission), *Internal Control–Integrated Framework* was revised in 2013.

factors, such as the significance of the controls being tested, the scope or extent of the controls being tested in relation to the overall financial statements of the client, and the frequency of the internal audit services.

.62 The Peer Review Board has also identified nonattest services as an area of focus for peer reviews conducted in 2015. There will be a new requirement that reviewed firms list on the engagement profile any nonattest services performed for the attest client during the period of the professional engagement or the period covered by the financial statements. Peer reviewers will then determine whether the reviewed firm has met the requirements of the "Nonattest Services" interpretation for the listed nonattest services. The requirements that peer reviewers will consider include the following:

- Whether the auditor determined that such a service would not impair independence before performing the nonattest service.
- Whether the member established and documented in writing his or her understanding with the client with regard to the following:
    - The objectives of the nonattest service engagement
    - The nonattest services to be performed
    - The client's acceptance of its responsibilities relative to the nonattest service
    - The auditor's responsibilities
    - Any limitations of the nonattest service engagement.
- The reviewer will also specifically focus on whether any nonattest services provided to the client resulted in the auditor assuming management responsibilities for the client and whether, in connection with the nonattest services provided, that client management performed all of the following functions:
    - Assumed all management responsibilities,
    - Oversaw the nonattest services by designating an individual, preferably within senior management, who possessed suitable skill, knowledge, or experience, or all
    - Evaluated the adequacy and results of the services performed
    - Accepted responsibility for the results of the nonattest services.

Audit Firm Rotation Proposals

.63 Recently, a number of regulators have proposed mandatory auditor rotation requirements, or announced that they were considering such requirements. The activity included the European Commission issuing a proposed rule that would require European public companies and their audit firms to

- limit the period that an outside auditing firm can perform audits of a company to six years, while companies that opt for a voluntary joint audit would be allowed a nine-year window;
- impose a cooling-off period of four years before a firm could audit again for the same client.

.64 Recently the European Union moved a step closer to a mandatory audit firm rotation requirement when the member states' Permanent Representatives Committee approved new audit regulations. The new regulations and amendments approved include a requirement that public-interest entities rotate engagements with audit firms every 10 years—with provisions for longer periods when engagements are put out for bid or joint audits are performed. Public-interest entities include banks, insurance firms, and listed companies. However, to take effect, the new regulations must still be approved by the European Parliament and the council of national governments.

.65 Regulations and amendments approved include the following:

- A 10-year maximum period during which a member state may allow an audit firm to continue auditing the same public-interest entity. If the engagement is put out for public bid, the member state may allow the engagement to continue for a maximum of 20 years. In cases of joint audits, where multiple audit firms share the engagement, the maximum period is 24 years.

- A prohibition on the provision of certain nonaudit services by audit firms to the public-interest entities they audit. Member states will have the right to allow firms to provide some tax and valuation services to their audit clients, provided they are immaterial and have no direct effect on the audited financial statements.
- A requirement that fees from permitted nonaudit services to an audit client cannot exceed 70 percent of the audit fees.

.66 In August 2011, the PCAOB issued a concept release on the topic of mandatory audit firm rotation, suggesting that it would enhance auditor independence, objectivity, and professional skepticism. It then held a number of public meetings to solicit the views of interested parties. In response to the release, the PCAOB received hundreds of letters, the vast majority of which opposed the idea for a variety of reasons, including the SEC's existing mandatory audit partner rotation rules. Similarly, the public meetings indicated that there was significant resistance to the idea, especially from publicly listed companies, their officers, and boards.

.67 However, during February 2014, it was widely reported that the PCAOB had abandoned its plans with respect to mandatory audit firm rotation. PCAOB Chairman James Doty apparently told the SEC that the PCAOB no longer has an active project or on-going work within the board to move forward with an auditor rotation rule. This came on the heels of activity on Capitol Hill, where in July 2013, the U.S. House of Representatives passed bipartisan legislation that prevents PCAOB from implementing a system of mandatory rotation for audit firms.

.68 United Kingdom regulators have also been weighing the idea of mandatory auditor rotation, and in 2013, the UK Competition Committee decided to forego mandatory rotation, suggesting instead that FTSE 350 companies should put their audit out to tender every five years. Also in 2013, another UK regulator, the Financial Reporting Council introduced a mandatory retendering every 10 years.

Recent PEEC Enforcement Actions

.69 The AICPA Professional Ethics Division enforces members' compliance with the AICPA Code of Professional Conduct via the Joint Ethics Enforcement Program, which is conducted in concert with participating state CPA societies. Investigations of violations of the code are performed by two subcommittees: the Technical Standards Subcommittee (TNS) and the Independence and Behavioral Standards Subcommittee (IND/BHS). The TNS investigates violations of all technical standards, whereas the IND/BHS investigates independence and behavioral standards, including tax standards.

.70 The following are examples of common disciplinary findings and the rules in the code to which they relate:[15]

- *General Standards* (Rule 201)
  - — Lack of due professional care when providing professional services, such as a balance sheet number not agreeing to a note
- *Compliance with Standards* (Rule 202)
  - — Failure to obtain sufficient competent evidential matter for one or more audit areas to support his or her opinion on the financial statements (AU-C section 500, *Audit Evidence* [AICPA, *Professional Standards*])[16]
  - — Failure to adequately document audit procedures performed (AU-C section 230, *Audit Documentation* [AICPA, *Professional Standards*])

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[15] Note: References to ethics rules and interpretations are to the code as it exists before the December 2014 effective date of the revised code.

[16] All AU-C sections are from AICPA *Professional Standards*.

- — Failure to dual date or redate a reissued report (Paragraph .41 of AU-C section 700, *Forming and Opinion and Reporting on Financial Statements*; paragraphs .12–.14 of AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*; and paragraphs .13–.15 of AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* [AICPA, *Professional Standards*])
- — Failure to identify and test all major programs in accordance with the Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations* Section .520, "Major Program Determination"
- — Overall compliance with clarified auditing standards, such as the auditor's opinion

- *Accounting Principles* (Rule 203)
  - — Failure to make required fair value disclosures (FASB ASC 820, *Fair Value Measurements*)
  - — Failure of the subsequent events note to comply with generally accepted accounting principles (GAAP) (FASB ASC 450-20-50, FASB ASC 855-10-50)
- *Acts Discreditable* (Rule 501)
  - — Inappropriate or no peer review being performed due to misrepresentation of a firm's practice (Peer reviewers are encouraged to check the Federal Audit Clearing House and the Department of Labor's [DOL's] EFAST2 websites to verify representations made by their peer review clients regarding their audit practice.)
  - — Failure to return client records and respond to request for records (supported by the "Response to requests by clients and former clients for records" interpretation[17])
  - — Failure to file tax returns (supported by the "Failure to file tax return or pay tax liability"[18])
- *Advertising and Other Forms of Solicitation* (Rule 502)
  - — Providing false or misleading information in advertising and soliciting (supported by the "False, misleading or deceptive acts in advertising or solicitation" interpretation[19])

.71 TNS finds that a majority of the technical violations can be attributed to a lack of adequate education. More detailed lists of the most frequent violations of the professional standards are available in two documents on aicpa.org:

- For investigations related to employee benefit plan audits, visit www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/EthicsEnforcement/DownloadableDocuments/EmployeeBenefitPlanReport.pdf.
- For investigations related to government and not-for-profit entities, visit www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/EthicsEnforcement/DownloadableDocuments/GovermentNotForProfitReport.pdf.

.72 The Professional Ethics Division educates members and promotes the understanding of ethical standards contained in the AICPA code by responding to member inquires on the application of the AICPA code to specific areas of practice. If you have questions, e-mail them to ethics@aicpa.org or call 888.777.7077. When prompted, select "6" on your keypad, followed by "1." If you are unable to make a selection on your keypad, a service representative will connect you to the Ethics Hotline. The Ethics Hotline fields more than 3,000 calls annually. The bulk of the calls are related to independence questions, and a large percentage of such calls concern the independence requirements when performing nonattest services.

[17] ET sec. 501 par. .02.
[18] ET sec. 501 par. .08.
[19] ET sec. 502 par. .03.

Ongoing AICPA PEEC Projects

Loans and Leases

.73 When FASB commenced its Leases Project several years ago, the PEEC established a task force to consider the impact that changes in the accounting for leases might have on the code and to propose related new or revised guidance.

.74 As the FASB has not yet completed its project, the PEEC task force is currently monitoring the FASB's progress. Once the project is finalized, the task force will consider the potential impact on the related guidance in the code.

Breaches of the Code—IFAC Convergence

.75 This IFAC Convergence Breaches of the Code Task Force is considering the IESBA standard on breaches of the code and whether such guidance would be appropriate for the AICPA Code of Professional Conduct. As a part of this project, the task force is looking at the AICPA Private Companies Practice Section (PCPS) informal guidance entitled "*Inadvertent Independence Violations Practice Tool*."[20] The Ethics Division will issue an exposure draft on this topic during the summer of 2014.

Suspected Fraud or Illegal Acts—IFAC Convergence

.76 A PEEC task force was also charged with the responsibility to respond to IESBA's exposure draft "Responding to a Suspected Illegal Act" and to make recommendations to the PEEC on any changes to the code in this area.

Definition of Client

.77 The Client Task Force is assessing what, if any, revisions are necessary to the definition of client to conform to the organizational independence requirements in the U.S. Government Accounting Office's (GAO's) *Government Auditing Standards* (the Yellow Book), and related issues.

Merged Firms

.78 The Merged Firm Task Force is considering whether additional independence guidance is needed for members when firms merge and a partner or professional employee of one firm is associated with an attest client of the other firm. The Task Force is also considering whether additional independence guidance is needed when one of the merged firms provided nonattest services that would impair independence to the attest client of the firm it is merging with.

Ability to Supervise or Participate in Investment Decisions

.79 A task force is considering whether the conclusions reached in the "Partnerships" and "Limited Liability Companies" sections of "Financial relationships," interpretation[21] concerning when a member has a direct financial interest are still appropriate, or if something broader might be more appropriate.

Campaign Treasurer

.80 This task force is determining whether the PEEC should undertake revising the guidance in "Campaign Treasurer."[22]

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[20] This tool is available at www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/DownloadableDocuments/InadvertentIndependenceViolationsPracticeTool.pdf.

[21] ET sec. 101 par. .17.

[22] ET sec. 191 par. .164; as of December 15, 2014, ET sec. 1.275.025.

Independence in State and Local Government Environment

.81 This task force will determine if any clarifications are necessary in "The effect on independence of relationships with entities included in the governmental financial statements."[23] If the PEEC deems revisions necessary, it will consider adding GASB citations to any terms that GASB defines that are included in the interpretation. It will also determine what the differences are between GASB's definition of basic financial statements and the AICPA's definition.

Three-Year Project Agenda

.82 The AICPA Professional Ethics Division maintains a three-year project agenda on its website that lists all current and future PEEC projects. The agenda is available at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/DownloadableDocuments/peec-three-year-agenda.pdf.

.83 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings, is available at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

Compliance Reminders Regarding Independence and Ethics Requirements of Other Authoritative Bodies

.84 The independence and ethics rules under the AICPA code apply to all members of the AICPA. However, in addition to these rules, other rule-making and standard-setting bodies, such as the SEC, PCAOB, GAO, DOL, IFAC, IRS, the U.S. Department of the Treasury, banking and insurance agencies, state boards of accountancy, and state CPA societies also have independence or ethics rules, or both, with which members must comply, to the extent such rules are applicable. The rules of some of these other bodies are discussed briefly in this alert. You should refer to the original text of each organization's rules for full guidance.

Continuing Professional Education Requirements

.85 State boards of accountancy typically have programs that test compliance with their CPE requirements. Certain boards have found significant noncompliance by some CPAs and they have levied fines and other sanctions against such licensees. Members are reminded to comply with all applicable CPE requirements, which can vary from state to state. Members who fail to comply with the CPE requirements of states or other regulatory bodies will also be considered to be in violation of the AICPA code.

SEC and PCAOB Independence Requirements

.86 Rule 2-01, "Qualifications of Accountants," of Regulation S-X, sets forth the SEC's independence rules. The rule is designed to ensure that auditors are qualified and independent of their audit clients, both in fact and appearance. Accordingly, the rule establishes restrictions on financial, employment, business relationships and fee relationships between an accountant and an audit client. In addition, the rule contains extensive restrictions on the provision of certain nonaudit services to an audit client and its affiliates.

.87 Rule 2-01 begins with a general standard of auditor independence, which states the following:

> The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission (Rule 2-01(b)).

[23] ET sec. 101 par. .12; as of December 15, 2014, ET sec. 1.224.020.

.88 The following paragraph reflects the application of the general standard to particular circumstances. In addition, the second preliminary note to Rule 2-01 states the following:

> The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in Rule 2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client.

.89 The rule indicates that the preceding factors are general guidance only, and their application may depend on particular facts and circumstances. Thus, Rule 2-01 also provides that

> in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services that are not explicitly described in the rule.

Audit Partner Rotation Requirements

.90 Members in public practice are reminded that lead audit partners, concurring or reviewing partners, and certain other partners on an audit engagement are required to rotate off their engagements after a specified period. Those periods are as follows:

- Lead and concurring or reviewing partners providing professional services on audit engagements may serve a maximum of five years on the engagement, after which they must remain off the audit engagement for another five years.
- Other partners, who make decisions on significant accounting, audit, or other reporting matters or who also have contact with the client's management and audit committee, are subject to rotation requirements after seven years of providing such professional services to the client. Upon rotation, the partner must remain off the audit engagement for two years.
- Partners whose services are limited to consulting with the audit engagement team on technical accounting, auditing, or similar issues are not required to rotate.

.91 The SEC's document, "Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions," addresses the extent to which a partner who has rotated off an entity's audit engagement may provide services to that entity.[24] FAQ No. 8 under "Audit Partner and Partner Rotation" reads as follows:

> **Question:** After a lead or concurring partner rotates off an audit engagement, may that partner provide services to the issuer in a specialty partner capacity (that is, providing tax services or national office/technical services) and still have this period continue to be considered part of the partner's rotation off the audit engagement?
>
> **Answer:** Any time audit partners spend time providing services which continue their direct relationship with the issuer, such time would not be considered as time off the audit engagement. However, limited discussions solely between the audit engagement team and a rotated-off partner generally would be considered as time off the audit engagement.

.92 A small firm exemption appears in SEC Rule 2-01(c)(6)(ii) of Regulation S-X and is as follows:

> Any accounting firm with less than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f)) and less than ten partners shall be exempt from Rule 2-01(c)(6)(i) of Regulation S-X provided the PCAOB conducts a review at least once every three years of

[24] This document can be found at www.sec.gov/info/accountants/ocafaqaudind080607.htm.

each of the audit client engagements that would result in a lack of auditor independence under this paragraph.

.93 Thus, a firm with four issuer audit clients and eight partners that is inspected by the PCAOB at least once every three years would qualify for the exemption. A critical distinction in the rule is that one should count all partners or other owners in the firm when determining whether the firm can use the exemption.

Staff Secondments

.94 The SEC independence rules, specifically Rule 2-01(c)(4)(vi) addressing nonaudit services, clearly prohibit a member of an accounting firm from acting as a member of management or as an employee. Acting as an employee includes a situation in which a firm seconds (that is, loans) staff to an audit client, including when the client's management will direct the staff's activities. Thus, even if the activity involves performing an otherwise permissible service (such as tax services), independence would be considered impaired.

.95 The SEC staff released additional guidance on this issue in January 2014.[25]

PCAOB Rules Regarding Independence and Ethics

.96 The PCAOB has the authority to establish ethics and independence standards in accordance with Section 103(a), "Auditing, Quality Control, and Ethics Standards," and Section 103(b), "Independence Standards and Rules," of the Sarbanes-Oxley Act of 2002 (SOX). Firms that issue audit reports on public companies are required to register with the PCAOB. Failure to do so may result in disciplinary action. Additionally, any registered public accounting firm, or person associated with such a firm, that fails to adhere to applicable PCAOB standards may be the subject of a PCAOB disciplinary proceeding in accordance with Section 105, "Investigations and Disciplinary Proceedings," of SOX. Under Section 107, "Commission Oversight of the Board," of SOX, PCAOB rules become effective only after they are approved by the SEC. The PCAOB independence and ethics rules include the following:

- PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board).[26]
- PCAOB Rule 3500T, *Interim Ethics and Independence Standards* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board).
- PCAOB Rules 3501–3526 (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board) describe the independence and ethics standards promulgated by the board and approved by the SEC since the board's inception.[27]

.97 PCAOB Rule 3100 generally requires all registered public accounting firms to adhere to the PCAOB's auditing and related professional practice standards, which encompass auditing, attestation, quality control, ethics, and independence standards, in connection with the preparation or issuance of any audit report for an issuer and in their auditing and related attestation practices. This rule also requires registered public accounting firms and their associated persons to comply with all applicable standards. Accordingly, if the PCAOB's standards do not apply to an engagement or other activity of the firm, PCAOB Rule 3100, by its own terms, does not apply to that engagement or activity.

.98 PCAOB issued Auditing Standard No. 16, *Communications with Audit Committees* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), on auditor communications with audit committees in August 2012. It is designed to enhance investor protection by providing timely and relevant communication between the auditor and an issuer's audit committee.

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[25] See www.sec.gov/litigation/investreport/34-71390.pdf.

[26] Subsequently mentioned PCAOB rules can be found in "Select Rules of the Board" in AICPA *PCAOB Standards and Related Rules*.

[27] The full text of these rules can be found at www.pcaobus.org/Standards/Pages/default.aspx.

Interim Ethics and Independence Standards

.99 PCAOB Rule 3500T sets forth ethics and independence standards for registered public accounting firms and their personnel. Pursuant to Rule 3500T, the PCAOB has provisionally designated the following rules of the AICPA Code of Professional Conduct as interim ethics and independence standards, to the extent not superseded or amended by the PCAOB:

- *Ethics*—Rule 102, *Integrity and Objectivity*, and its interpretations and rulings thereunder, as they existed on April 16, 2003
- *Independence*—Rule 101, *Independence*, and its interpretations and rulings thereunder, as they existed on April 16, 2003

.100 The PCAOB has provisionally designated the following rules and interpretation of the Independence Standards Board (ISB) as interim independence standards, to the extent not superseded or amended by the PCAOB:[28]

- ISB Standard No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards)
- ISB Standard No. 3, *Employment with Audit Clients* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards)
- ISB Interpretation No. 99-1, "Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)" (AICPA, *PCAOB Standards and Related Rules*, Interim Standards)

.101 In addition, the PCAOB requires compliance with the SEC's independence rules. The PCAOB's interim independence standards are not to be interpreted to supersede the SEC's independence requirements. Therefore, to the extent that a provision of the SEC's rule or policy is more restrictive—or less restrictive—than the PCAOB's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive requirement.

.102 To the extent that the SEC's rules are more or less restrictive than the PCAOB's interim independence standards, registered public accounting firms must comply with the more restrictive requirements.

Federal Deposit Insurance Corporation

Applicability of Independence Standards to Audits of Insured Depository Institutions

.103 Depending upon the insured depository institution (bank or financial institution) audit client, an external auditor is subject to the independence standards issued by one or more of the following standard-setters: the AICPA, the SEC, and the PCAOB. For nonpublic financial institutions[29] that are not required to have annual independent audits pursuant to either Part 363[30] of the Federal Deposit Insurance Corporation (FDIC's) regulations or Section 562.4[31] of the Office of Thrift Supervision's (OTS's) regulations, the external auditor must comply with the AICPA's independence standards; the financial institution's external auditor is not required to comply with the independence standards of the SEC and the PCAOB.

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[28] You can find the full text of the rules and the interpretation at http://pcaobus.org/Standards/Pages/default.aspx. You can also find them in the "Interim Standards" section of AICPA's *PCAOB Standards and Related Rules*.

[29] *Nonpublic financial institutions* are companies that are not, or whose parent companies are not, subject to the reporting requirements of the Securities Exchange Act of 1934 (the 1934 Act).

[30] Part 363 of the FDIC's regulations implements Section 36 of the Federal Deposit Insurance Act (FDI Act). Part 363 and Section 36 can be found at www.fdic.gov/regulations/laws/rules/2000-8500.html and www.fdic.gov/regulations/laws/rules/1000-3800.html#fdic1000sec.36 respectively. Also, the link to the FDIC's Financial Institution Letter 33-3009, which includes the Final Rule regarding the most recent amendments to Part 363, is www.fdic.gov/news/news/financial/2009/fil09033.html.

[31] As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, supervision of certain Office of Thrift Supervision (OTS) thrifts was transferred to the Office of the Comptroller of the Currency and the FDIC, and the supervision of the Savings and Loan Holding Companies was transferred to the Board of Governors of the Federal Reserve System. These agencies are in the process of proposing rulemaking and incorporating the relevant OTS rules and regulations into their respective rules and regulations for the OTS institutions and thrift holding companies for which they assumed responsibility. Readers are encouraged to visit the agencies' websites for the most current information on the status of the agencies' rulemaking processes.

.104 In contrast, for financial institutions subject to the audit requirements, either in Part 363 of the FDIC's regulations or in Section 562.4 of the OTS's regulations, the external auditor should be in compliance with the independence standards of the AICPA, the SEC, and the PCAOB. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, the independent public accountant must comply with the more restrictive rule.

.105 Generally, when an insured depository institution that is neither a public company nor the subsidiary of a public company becomes subject to Part 363 of the FDIC's regulations for the first time, the external auditor is required to be independent under the SEC and the PCAOB's independence rules for all periods included in the insured depository institution's initial Part 363 Annual Report. These independence requirements are similar to the SEC's independence requirements when an entity files with the SEC for initial public offering.

.106 For financial institutions and bank holding companies that are public companies,[32] regardless of size, the external auditor should be in compliance with the SEC's and the PCAOB's independence standards, as well as the AICPA's independence standards.

.107 The following table illustrates the applicability of the AICPA, SEC, and PCAOB independence standards:

Applicability of Auditor Independence Standards	*AICPA Independence Standards*	*SEC Independence Standards*	*PCAOB Independence Standards*
Scenario 1			
Nonpublic institutions **not** subject to Part 363 of the FDIC's regulations or Section 562.4 of the Office of Thrift Supervision's (OTS's) regulations	Yes	No	No
Scenario 2			
Public and nonpublic institutions subject to Part 363 of the FDIC's regulations or Section 562.4 of the OTS's regulations	Yes	Yes	Yes
Scenario 3			
Institutions and holding companies that are public companies (regardless of size)	Yes	Yes	Yes

International Ethics Convergence and Monitoring

.108 As business has become increasingly global, the visibility and applicability of the IESBA code has grown. For example, a firm that audits a U.S. subsidiary of a foreign parent typically must confirm its compliance with the IESBA code to the parent company's auditor.

.109 A few other examples follow:

- A local firm is part of a global accounting association that is deemed, under international standards, to be a network. All firms in the network must be independent of the other network firms' audit and review clients in accordance with those standards. In fact, the network typically requires its members to meet global ethics standards on all multinational assurance engagements.

[32] *Public companies* are companies, or subsidiaries of companies, that are subject to the reporting requirements of the 1934 Act.

- A regional firm in southern California serves as auditor of a small Los Angeles-based software developer that acquires a company in Bangalore, India. The Indian company's significant vendors, and its lenders, usually expect to rely on the California firm's audit report and, thus, they typically expect that firm to comply with IESBA requirements.
- A small firm's client expands its business by opening a branch office in Argentina. Lessors, vendors, and lenders in Argentina ask the firm to audit the client's financial information in accordance with international auditing standards, which will call for the firm to comply with IESBA ethics and independence standards.

.110 The most recent version of the IESBA code has been effective since January 1, 2011. The IESBA publishes a "Handbook of the Code of Ethics for Professional Accountants" each year and the 2013 version contains a number of changes that were adopted by the IESBA during 2013 but have effective dates in 2014. The current IESBA Handbook (2013 version) can be found online at www.ifac.org/sites/default/files/publications/files/2013-IESBA-Handbook.pdf.

Resource Central

Continuing Professional Education

.111 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following specifically related to the independence and ethics:

- *Cost and Return: Professional Ethics in Business* (product no. 159891 [online])
- *Ethics: Non-Attest Services, Integrity and Objectivity* (159416 [online])
- *Business Ethics Accounting and Auditing: Real-World Business Ethics for CPAs in A&A* (product no. 733606 [text])
- *Independence* (product no. 159182 [online])
- *Professional Ethics: 2012/2013 Update and Refresher* (product no. 159434 [online])
- *Professional Ethics and Responsibilities in Tax Practice* (product no. 738704HS [CD-ROM], 158703 [online]
- *Professional Ethics: AICPA's Comprehensive Course* (product no. 732317 [text])
- *Professional Ethics: Complying With the GAO Rules* (product no. 739442HS [CD-ROM], 159442 [online])
- *Professional Ethics for CPAs in Business* (product no. 738903HS [CD-ROM], 158902 [online])
- *Real World Business Ethics* (product no. 733596001 [text])
- *Business Ethics—Real World Business Ethics: How Will You React?* (product no. 732040001 [text])
- *Business Ethics for Tax: Real Word Business Ethics for Tax Practitioners* (product no. 733616 [text])
- *Selected Topics in Professional Ethics* (product no. 158387 [online])

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.112 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. Divided into one-credit and two-credit courses that are available 24 hours a day, seven days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Subscriptions are available at www.cpa2biz.com/AST/AICPA_CPA2BIZ_Pages/C2BOnlineSubscriptionsPage/Section2/PRDOVR~PC-BYF-XX/PC-BYF-XX.jsp (product no. BYF-XX).

.113 Some courses covering topics of special interest to the independence and ethics include the following:

- *Compilations and Reviews: Independence Considerations*
- *Comp & Review Engagements: Current Engagement Environment and Recent SSARS Development*
- *A&A Issues Facing CPAs: Government Audit Standards and Independence*
- *Ethics: BAN&K Advisory Services LLC—You Are the Advisory Services Partner*
- *Ethics: Bank of Little Beach—You are the Valuation Specialist*
- *Ethics: Forensic Review Services LLC—You Are the Forensic Investigator*
- *Ethics: Megatron Corp.—You Are the Corporate Controller*
- *Ethics: Pointer Electronics, Inc.—You Are the Engagement Quality Review (Concurring) Partner*
- *Ethics: Precious Mining, Inc.—You Are the Audit Committee Chair*
- *Ethics: Superlative Software Corp.—You Are the CFO*
- *Ethics: You are the Amended Return Preparer and You are the Outside Tax Advisor*
- *Ethics: You are the Outside Attorney for the Controller and You are the Tax Return Preparer*

To register for individual courses or to learn more, visit www.cpa2biz.com.

Webcasts

.114 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high-quality CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available for viewing. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.115 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at 888.777.7077.

Hotlines

Accounting and Auditing Technical Hotline

.116 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. ET on weekdays. You can reach the Technical Hotline at 877.242.7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.117 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

AICPA Online Professional Library: Accounting and Auditing Literature

.118 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. You can also sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC; the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Best Practices in Presentation and Disclosure*; and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Codified Clarity Standards

.119 The best way to obtain the codified clarity standards is with a subscription to AICPA *Professional Standards* in the AICPA Online Professional Library. Although the individual Statements on Auditing Standards are available in paperback, this online codified resource is what you need to update your firm audit methodology and begin understanding how clarity standards change certain ways you perform your audits. For online access to AICPA *Professional Standards* visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Specials/MostPopularProductGroups/AICPAResourceOnline/PRD~PC-005102/PC-005102.jsp.

.120 You can also get the clarified standards in paperback format. *Codification of Statements on Auditing Standards* is published each spring and includes the clarified auditing standards and the attestation standards. *Professional Standards*, which has the full complement of AICPA standards, is published each summer.

.121 The codification of clarified standards includes various resources:

- A preface, "Principles Underlying the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards"
- A glossary of terms defined in the standards
- Appendixes describing the differences between generally accepted auditing standards and the International Standards on Auditing

Financial Reporting Center of AICPA.org

.122 CPAs face unprecedented changes in financial reporting. As such, the AICPA has created the Financial Reporting Center to support you in the execution of high-quality financial reporting. This center provides exclusive members-only resources for the entire financial reporting process, and can be accessed at www.aicpa.org/frc.

.123 The Financial Reporting Center provides timely and relevant news, guidance, and examples supporting the financial reporting process. You will find resources for accounting, preparing financial statements, and performing various types of engagements, including compilation and review, audit and attest, and assurance and advisory.

.124 For example, the Financial Reporting Center offers a dedicated section to the Clarity Project. For the latest resources available to help you implement the clarified standards, visit the "Improving the Clarity of Auditing Standards" page at www.aicpa.org/SASClarity.

Industry Websites

.125 The Internet covers a vast amount of information that may be valuable to auditors, including current industry trends and developments. Some of the more relevant sites for ethics and independence issues follow:

Organization	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Professional Ethics Executive Committee (PEEC)	AICPA Code of Professional Conduct; PEEC standards-setting projects and meeting information; information on the ethics enforcement process, including discipline actions, as well as an array of other resources	www.aicpa.org/InterestAreas/ProfessionalEthics/Pages/ProfessionalEthics.aspx
Board of Governors of the Federal Reserve System	Advisory dated 2006 regarding the use of limitation of liability provisions in engagement letters with public and nonpublic financial institutions	www.federalreserve.gov/boarddocs/srletters/2006/SR0604a1.pdf
Department of Labor (DOL)	DOL Regulation 2509.75-9, *Interpretive bulletin relating to guidelines on independence of accountant retained by Employee Benefit Plan*, and contact information	www.dol.gov
Government Accountability Office	*Government Auditing Standards* independence standard, frequently asked questions on independence, slide presentation on independence, and contact information	www.gao.gov/yellowbook
Federal Deposit Insurance Corporation (FDIC)	FDIC regulations (12 CFR Part 363), *Annual Independent Audits and Reporting Requirements*	www.fdic.gov/regulations/laws/rules/2000-8500.html#fdic2000part3630
International Federation of Accountants	Pronouncements, projects, and key contacts of the International Ethics Standards Board for Accountants (IESBA), including the IESBA's *Code of Ethics for Professional Accountants*	www.ifac.org/Ethics
PCAOB	Information on accounting and auditing activities of the PCAOB, including those on independence	www.pcaob.org

Organization	*Content*	*Website*
SEC	Information from the Office of the Chief Accountant for accountants and auditors, including independence; current SEC rule making; final rule releases 33-8183A and 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence*; and key contact information	www.sec.gov

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Appendix—Plain English Guide to Independence

A plain-English description of the AICPA independence rules follows. The purpose of this appendix is to help you understand independence requirements under the AICPA Code of Professional Conduct (AICPA Code) and, if applicable, other rule-making and standard-setting bodies. Independence generally implies one's ability to act with integrity and exercise objectivity and professional skepticism. The AICPA and other rule-making bodies have developed rules that establish and interpret independence requirements for the accounting profession. We use the term *rules* broadly to also mean standards, interpretations, rulings, laws, regulations, opinions, policies, or positions. This guide discusses in plain English the independence requirements of the principal rule-making bodies in the United States, so you can understand and apply them with greater confidence and ease.

This appendix is intentionally concise, so it does not cover all the rules (some of which are complex), nor does it cover every aspect of the rules herein. Nonetheless, this guide should help you identify independence issues that may require further consideration. Therefore, you should always refer directly to the rules, in addition to your firm's policies on independence, for complete information.

Conventions and Key Terms Used

Some of the conventions used are described in the following list:

- The word ***Note*** in boldface italics emphasizes important points, highlights applicable government regulations, or indicates that a rule change may soon occur.
- AICPA interpretations and rulings to the AICPA Code are linked.
- Internet addresses (URLs) and hyperlinks to other sources of information are provided.
- Information on additional resources appears at the end of this appendix to help you resolve your independence issues. (See the question "Where Can I Find Further Assistance With My Independence Questions?" in this appendix)

> We describe the rules of the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB)—that is, those that apply to audits of SEC registrants and issuers—in boxed text (like this one) and provide citations to specific rules. Generally, we provide these descriptions when the SEC and the PCAOB either impose additional requirements, or their rules otherwise differ from the AICPA rules.

The following key terms are used:

Client (or **attest client**). An entity with respect to which independence is required.

Firm. A form of organization permitted by law or regulation (whose characteristics conform to resolutions of the AICPA Council) that is engaged in the practice of public accounting.

SEC registrant. An issuer filing an initial public offering, a registrant filing periodic reports under the securities laws, a sponsor or manager of an investment fund, or a foreign private issuer that is (or is in the process of becoming) an SEC registrant. In this appendix, *SEC audit client* means an *SEC registrant* and its *affiliates*, as defined in the SEC rules.

Issuer. An entity whose securities are registered under the securities laws or that is required to file reports under Section 10(A) of the Securities Exchange Act of 1934 or that files, or has filed, a registration statement that has not yet become effective under the Securities Act of 1933.

Note: Certain SEC registrants (for example, broker-dealers and hedge funds) are not issuers (that is, they are nonissuers). Though these entities' auditors must be registered with the PCAOB, currently, they are not subject to the PCAOB independence rules and are exempt from certain SEC independence rules. However, due to the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the PCAOB has expanded its jurisdiction to include all registered broker-dealer auditors and is in the process of considering a permanent inspection program, as well as new or revised audit and independence standards for these auditors.

Introduction

What Is Independence?

Independence is defined in ET section 100-1, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*), and is referred to herein as the *conceptual framework*, as follows:

Independence of mind. The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

Independence in appearance. The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or member of the attest engagement team had been compromised.

These definitions reflect the long-standing professional requirement that members who provide services to entities for which independence is required be independent both in fact (that is, of mind) and in appearance.

What Should I Do If No Specific Guidance Exists on My Particular Independence Issue?

The "Other Considerations" section of Interpretation No. 101-1, "Interpretation of Rule 101," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .02), recognizes that it is impossible for the AICPA Code to identify all circumstances in which the appearance of independence might be questioned.

Specifically, Interpretation No. 101-1 requires that members use the conceptual framework when making independence decisions involving matters that are not specifically addressed in the independence interpretations and rulings in the AICPA Code. When threats to independence are not at an acceptable level, the member must apply safeguards to eliminate the threats or reduce them to an acceptable level. If threats to independence are not at an acceptable level and require the application of safeguards, the member must document the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level.

The conceptual framework provides a valuable tool to help you comply with the requirement in the "Other Considerations" section of Interpretation No. 101-1 to evaluate whether a specific circumstance that is not addressed in the AICPA Code would pose an unacceptable threat to your independence.

When Is Independence Required, and Who Sets the Rules?

AICPA professional standards require your firm, including the firm's partners and professional employees, to be independent in accordance with Rule 101 whenever your firm performs an attest service for a client. Attest services include the following:

- Financial statement audits
- Financial statement reviews
- Other *attest services*, as defined in the Statements on Standards for Attestation Engagements

Performing a compilation of a client's financial statements does not require independence. However, if a nonindependent firm issues such a compilation report, the report should include an indication of the accountant's lack of independence pursuant to paragraph .21 of AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*).

You and your firm are not required to be independent to perform services that are not attest services (for example, tax preparation or advice or consulting services, such as personal financial planning), if they are the only services your firm provides to a client.

Note: You should familiarize yourself with your firm's independence policies, quality control systems, and list or database of attest clients.

In Addition to the AICPA, Who Else Sets Independence Rules?

Many clients are subject to oversight and regulation by governmental agencies. For example, the Government Accountability Office (GAO) sets independence rules that apply to entities audited under *Government Auditing Standards* (also referred to as the Yellow Book). For these clients (and others, such as those subject to regulation by the SEC or Department of Labor [DOL]), you and your firm also must comply with the independence rules established by those agencies.

The SEC regulates SEC registrants and issuers and establishes the qualifications of independent auditors. This section refers to these independence rules as *SEC rules*.

The PCAOB, a private standard-setting body whose activities are overseen by the SEC, is authorized to set, among other things, auditing, attestation, quality control, ethics, and independence standards for accounting firms that audit issuers. The PCAOB adopted interim ethics standards based on the following provisions of the AICPA Code: Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, ET sec. 102 par. .01); Rule 101; and interpretations and rulings under those rules. It also adopted Independence Standards Board (ISB) standards. To the extent that the SEC's rules are more or less restrictive than the PCAOB's interim independence standards, registered public accounting firms must comply with the more restrictive requirements.

In addition to its detailed rules, the SEC looks to its general standard of independence and four basic principles to determine whether independence is impaired. The general standard is an appearance standard that considers whether a reasonable investor with knowledge of all relevant facts and circumstances would conclude that an accountant is independent.

Under the four basic principles, an auditor cannot (1) function in the role of management, (2) audit his or her own work, (3) serve in an advocacy role for the client, or (4) have a mutual or conflicting role with the client.

Other organizations that establish independence requirements that may be applicable to you and your firm include the following. You should contact these organizations directly for further information:

- State boards of accountancy
- State CPA societies
- Federal and state agencies

Note: Generally, the AICPA independence rules will apply to you in all situations involving an attest client. If an additional set of rules governing an engagement also applies, you should comply with the most restrictive rule or the most restrictive portions of each rule.

Once you determine that your firm provides attest services to a client and which rules apply, the next step is to determine how the rules apply to you.

Applying the Rules—Client and Client Affiliates

Do I Need to Remain Independent From Just My Client or to Other Entities, As Well?

Although, generally, we think of our clients as the entity for which we are performing an attest engagement, in some instances, you will need to remain independent from other entities. Specifically, if the engaging party is not the entity you are performing the attest engagement on, the AICPA Code requires that you also remain independent of the engaging party.

Come January 1, 2014, the AICPA Code will require you to remain independent of affiliates of any financial statement attest client. A financial statement attest client is considered to be any entity whose financial statements are audited, reviewed, or compiled when the member's compilation report does not disclose a lack of independence.

What Entities Are Considered Affiliates of My Financial Statement Attest Client?

Interpretation No. 101-18, "Application of the Independence Rules to Affiliates," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .20), was added to the AICPA Code in November 2011. Although this interpretation may be implemented early, it is effective for engagements covering periods beginning on or after January 1, 2014, so you have a little time left to eliminate any prohibited relationships.

Following are the entities that will need to be considered affiliates of your client:

a. An entity (for example, subsidiary, partnership, or limited liability company [LLC]) that a financial statement attest client can control.

b. An entity in which a financial statement attest client or an entity controlled by the financial statement attest client has a direct financial interest that gives the financial statement attest client significant influence over such entity and is material to the financial statement attest client.

c. An entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity.

d. An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.

e. A sister entity of a financial statement attest client if the financial statement attest client and sister entity are each material to the entity that controls both.

f. A trustee that is deemed to control a trust financial statement attest client that is not an investment company.

g. The sponsor of a single employer employee benefit plan financial statement attest client.

h. Any union or participating employer that has significant influence over a multiple or multiemployer employee benefit plan financial statement attest client.

i. An employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client. A financial statement attest client that sponsors an employee benefit plan includes, but is not limited to, a union whose members participate in the plan and participating employers of a multiple or multiemployer plan.

j. An investment adviser, a general partner, or a trustee of an investment company financial statement attest client (fund) if the fund is material to the investment adviser general partner or trustee, and they are deemed to have either control or significant influence over the fund. When considering materiality, members should consider investments in, and fees received from, the fund.

What Do I Do If a Financial Statement Attest Client's Affiliates Can't Be Identified?

If after expending your best efforts to obtain the information to identify the affiliates of a financial statement attest client, you are unable to do so, all the following steps must be taken:

- Discuss the matter, including the potential impact on independence, with those charged with governance.
- Document the results of the discussion with those charged with governance.
- Document the efforts taken to obtain the information to identify the affiliates of the financial statement attest client.
- Obtain written assurance from the financial statement attest client that it is unable to provide the member with the information necessary to identify the client's affiliates.

Are There Any Exceptions to the Affiliate Rules?

Although the interpretation requires members to apply the independence provisions applicable to their financial statement attest clients to any affiliates, it was deemed appropriate and necessary to make four exceptions to this conclusion.

The first exception involves loans and applies to all affiliates. The AICPA Code currently prohibits a covered member from making a loan to, or having a loan from, an individual who is an officer, a director, or a 10 percent or more owner of an attest client. If this provision were applied to affiliates any time a member had a loan to or from an individual, especially one that is only an investor and not in a position of governance, he or she would need to take steps to ensure the individual was not in one of these positions at an affiliate. Accordingly, the exception concludes that only when the covered member has knowledge that the individual is in such a position with an affiliate of a financial statement attest client, the covered member should be required to consult the conceptual framework because without knowledge, the familiarity, undue influence, and financial self-interest threats would be at an acceptable level.

The second, third, and fourth exceptions may not be applied by those described as an affiliate under (a) or (b); rather, they may only be applied to those described as an affiliate under (c)–(j).

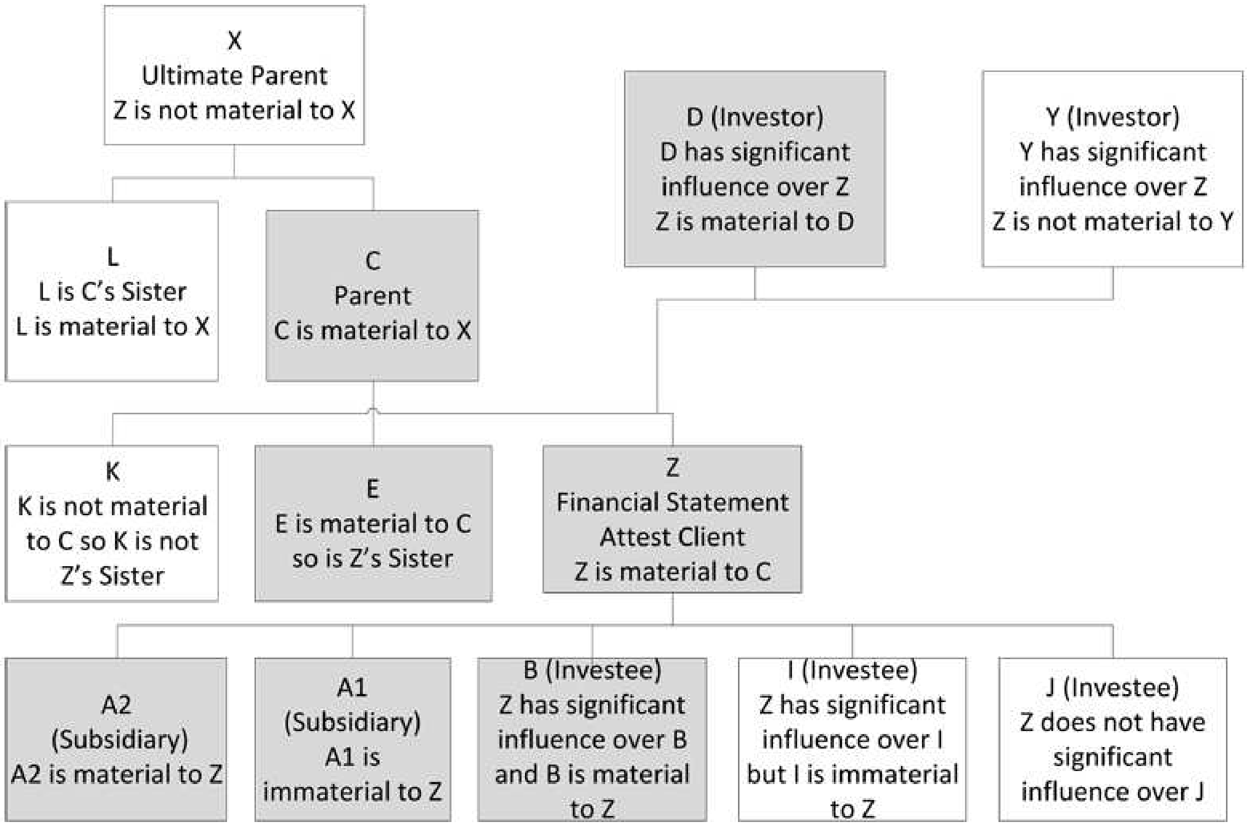
The second exception involves the provision of prohibited nonattest services. Specifically, when it is reasonable to conclude that the prohibited nonattest services do not create a self-review threat because the results of the nonattest services will not be subject to financial statement attest procedures, and any other threats that are created by the provision of the nonattest service (for example, management participation threats) that are not at an acceptable level are eliminated or reduced to an acceptable level by the application of safeguards, members should not be prohibited from providing these services to entities described as an affiliate under (c)–(j). This exception does not apply to those entities described as an affiliate under (a) or (b).

The third exception involves subsequent employment at an affiliate. The AICPA Code (that is, Interpretation No. 101-2, "Employment or Association With Attest Clients," under Rule 101 [AICPA, *Professional Standards*, ET sec. 101 par. .04]) currently requires the application of six specific safeguards when a former partner or employee becomes employed at an attest client in a key position. Under the proposed interpretation, if no exception were provided, these six safeguards would need to be applied when a former partner or employee becomes employed or associated with an affiliate in a key position. It was determined that it is not necessary to apply these safeguards to entities described as an affiliate under (c)–(j) if the individual's position does not allow the individual to be in a key position with respect to the financial statement attest client. Again, this exception does not apply to those entities described as an affiliate under (a) or (b).

The fourth exception involves immediate family members and close relatives who are employed at those entities described as an affiliate under (c)–(j). Similar to the third exception previously described, covered members need only be concerned with employment positions their immediate family members and close relatives have with such affiliates when these positions put them in a key position with respect to the financial statement attest client at those defined as an affiliate under (a) and (b).

Is There a Visual Aid to Help Me Understand the Affiliate Definitions?

Definitions (a)–(e) are subsequently shown and identified by the grey shaded boxes.



Is There an Executive Summary of the Interpretation?

	Affiliate									
Type of Relationship	*A*	*B*	*C*	*D*	*E*	*F*	*G*	*H*	*I*	*J*
Financial Interest In	P	P	P	P	P	P	P	P	N/A	P
Loan To or From	PS	PS	PS	PS	PS	PS	PS	PS	PS	PS
Nonattest Services Provided To	P	P	NSA	NSA	NSA	NSA	NSA	NSA	NSA	NSA
Member's Employment or Association With	P	P	A	A	A	A	A	A	A	A
Former Employment or Association With	P	P	P	P	P	P	P	P	P	P

(continued)

	Affiliate									
Type of Relationship	*A*	*B*	*C*	*D*	*E*	*F*	*G*	*H*	*I*	*J*
Immediate Family Employment or Interest In	P	P	R	R	R	R	R	R	R	R
Close Relative Employment or Interest In	P	P	R	R	R	R	R	R	R	R

Tick Mark Key

P: The independence provisions contained in the AICPA Code of Professional Conduct should be applied to this affiliate

PS: A member may have a loan to or from an individual who is an officer, a director, or a 10 percent owner of an affiliate; however, if the covered member has knowledge of the individual's relationship with the affiliate, he or she should consult ET section 100-1, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*).

A: Firm will have to apply conditions (1)–(6) in Interpretation No. 101-2, "Employment or Association With Attest Clients," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .04), if the former employee is in a key position at the affiliate. Even if position is a nonkey position, when considering employment, the individual must report the consideration to the appropriate person in the firm and be removed from the engagement.

R: Immediate family members and close relatives of a covered member may be employed at an affiliate, as long as their position does not put them in a key position with respect to the financial statement attest client.

NSA: Services are permitted if not subject to audit; see the second exception for details.

N/A: The relationship is not applicable.

Definitions of Affiliates

Affiliate A: Entity that a financial statement attest client can control.

Affiliate B: An entity in which a financial statement attest client or an entity controlled by the financial statement attest client has a direct financial interest that gives the financial statement attest client significant influence over such entity and is material to the financial statement attest client.

Affiliate C: An entity that controls a financial statement attest client when the financial statement attest client is material to entity.

Affiliate D: An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.

Affiliate E: Sister entity of a financial statement attest client if the financial statement attest client and sister are material to the entity that controls both.

Affiliate F: Trustee that is deemed to control a trust financial statement attest client that is not an investment company.

Affiliate G: Sponsor of a single employer employee benefit plan financial statement attest client.

Definitions of Affiliates

Affiliate H: Union or participating employer having significant influence over a multiple or multiemployer employee benefit plan financial statement attest client.

Affiliate I: Employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client.

Affiliate J: Investment adviser, general partner, and trustee of an investment company financial statement attest client (the fund) if the fund is material to the investment adviser, general partner, or trustee, and they are deemed to have either control or significant influence over the fund.

Applying the Rules—Covered Members and Other Firm Professionals

How Do the Independence Rules Apply to Me?

Whenever you are a covered member, you become subject to the full range of independence rules with regard to a specific client. You are a covered member if you are any of the following:

1. An individual on the client's attest engagement team
2. An individual in a position to influence the client's attest engagement
3. A partner or manager who provides more than 10 hours of nonattest services to the attest client
4. A partner in the office in which the lead attest engagement partner primarily practices in connection with the client's attest engagement
5. The firm, including the firm's employee benefit plans
6. An entity whose operating, financial, or accounting policies can be controlled[1] by any of the individuals or entities described in items 1–5 or by 2 or more such individuals or entities if they act together

The SEC uses the term *covered person*[2] to describe the individuals in a firm who are subject to SEC independence rules. This term is largely consistent with the AICPA's term *covered member*. The only difference between the two definitions is that of classification. The AICPA considers consultants to be in a position to influence the engagement (the SEC uses the term *chain of command*), whereas the SEC considers these persons to be on the attest engagement team. Overall, the definitions are the same.

Note: This alert uses the term *covered member* (and *covered person* with respect to SEC rules) extensively in explaining the "personal" independence rules (for example, rules that apply to you and your family's loans, investments, and employment). Therefore, it is important that you understand these terms before proceeding. Also, remember to check your firm's policies to determine whether they are more restrictive than the AICPA or SEC rules.

Do Any of the Rules Apply to Me If I Am Not a Covered Member?

Yes, these rules apply in certain circumstances, even if you are not a covered member. Due to their magnitude, two categories of relationships impair independence, even if you are not a covered member. These relationships are defined as follows:

- Director, officer, or employee (or in any capacity equivalent to a member of management) of the client, promoter, underwriter, voting trustee, or trustee of any of the client's employee benefit plans
- Owner of more than 5 percent of an attest client's outstanding equity securities (or other ownership interests)

[1] For consolidation purposes, as defined by accounting principles generally accepted in the United States of America.

[2] See Rule 2-01(f)(11). Also, see "Covered Persons in the Firm," in the Security and Exchange Commission' s (SEC's) Final Rule Release [Section IV (H)(9)].

The independence rules prohibit these relationships if you are a partner or professional employee in a public accounting firm.

What If I Was Formerly Employed by a Client, or I Was a Member of the Client's Board of Directors?

You must be aware of a number of things, including the following:

- You may not participate in the client's attest engagement or be in a position to influence the engagement for any periods covering the time you were associated with the client. So, for example, if you worked for the client in 2012, you would be prohibited from serving on the client's audit engagement for the fiscal year 2012 financial statements. You also could not serve in a position that would allow you to influence the fiscal year 2012 engagement (for example, you could not directly or indirectly supervise the audit engagement partner).
- Before becoming a covered member, you must do the following:
  - Dispose of any direct or material indirect financial interests in the client.[3]
  - Collect and repay all loans to or from the client (except those specifically permitted or grandfathered).[4]
  - Cease active participation in the client's employee health and welfare plans unless the client is legally required to allow your participation in the plan (for example, through the Consolidated Omnibus Budget Reconciliation Act), and you timely pay 100 percent of your portion of the cost to participate.
  - Cease to participate in all other employee benefit plans by liquidating or transferring all vested benefits in the client's defined benefit plans, defined contribution plans, share-based compensation arrangements, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. When the covered member does not participate on the attest engagement team or is not in a position to influence the attest engagement, he or she is not required to liquidate or transfer any vested benefits if such an action is not permitted under the terms of the plan or if a penalty[5] significant to the benefits is imposed upon such liquidation or transfer.
  - Assess if you have any other relationships with the client to determine if such relationships create threats to independence that would require the application of safeguards to reduce the threats to an acceptable level.[6]

What Rules Apply If I Am Considering Employment With an Attest Client?

If an attest client offers you employment, or you seek employment with an attest client, you may need to take certain actions. If you are on that client's attest engagement team or can otherwise influence the engagement, you must promptly report any employment negotiations with the client to the appropriate person in your firm. You cannot participate in the engagement until your negotiations with the client end.

What If I Accept Employment or a Board Position With an Attest Client?

Being employed by a client or a member of the client's board of directors impairs independence. However, even if you leave your firm to take a position with a client, independence still may be affected. This would be the case if you accept a key position with the client, which means that you prepare financial statements or accounting records or are otherwise able to influence the client's statements or records. A few examples of key positions are controller, CFO, or treasurer. Remember that the substance, not only the position title, determines whether a position is considered "key."

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[3] See the section, "When Do My (or My Family's) Financial Interests Impair Independence?" in this appendix.

[4] Also, see Interpretation No. 101-5, "Loans From Financial Institution Clients and Related Terminology," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .07).

[5] A penalty includes an early withdrawal penalty levied under the tax law but excludes other income taxes that would be owed, or market losses that may be incurred, as a result of the liquidation or transfer.

[6] See the section, "What Should I Do If No Specific Guidance Exists on My Particular Independence Issue?" in this appendix.

If you meet the following conditions, having a key position with a client will not impair your firm's independence:

- The amounts the firm owes you (capital balance or retirement benefits) are based on a fixed formula and are not material to the firm.
- You cannot influence the firm's operations or financial policies.
- You do not participate or appear to participate in the firm's business or professional activities.

Your firm must consider whether it should apply additional procedures to ensure that your transition to the client has not compromised the firm's independence and that independence will be maintained going forward. Some things the firm should consider are as follows:

- Whether you served on the engagement team and for how long
- Positions you held with the firm and your status
- Your position and status with the client
- The amount of time that has passed since you left the firm

Based on these factors, the firm may decide to

- adjust the audit plan to reduce the risk that your knowledge of the plan could lessen the audit's effectiveness.
- reconsider the successor engagement team to ensure it has sufficient stature and experience to deal effectively with you in your new position.
- perform an internal technical review of the next attest engagement to determine whether engagement personnel exercised the appropriate level of professional skepticism in evaluating your work and representations.[7]

Under SEC rules, if a former partner will be in an accounting role or financial reporting oversight role with an SEC audit client, he or she may not have the following:

- A capital balance with the firm
- A financial arrangement with the firm (for example, retirement benefits) that is not fully funded by the firm
- Influence over the firm's operations or financial policies

The SEC uses the terms *accounting role* and *financial reporting oversight role*[8] in its rules; taken together, these terms are consistent with the AICPA term *key position*. The SEC also requires a one-year cooling-off period for members of the audit engagement team of an issuer who assume a financial reporting oversight role with the client. In other words, if an engagement team member who participated on the audit of the current (or immediately preceding) fiscal year goes to work for a client, the firm's independence would be impaired.

Only members who provided fewer than 10 hours of audit, review, or other attest services to the client (and did not serve as either the lead or concurring partner for the client) would be excluded from the audit engagement team for purposes of this rule.

This rule applies to an issuer and its consolidated entities.

[7] An objective professional with the appropriate stature and expertise should perform this review, and the firm should take any recommendation(s) that result from the review.

[8] *Accounting role* or *financial reporting role* means a role in which a person is in a position to or does exercise more than minimal influence over the contents of the accounting records or anyone who prepares them or exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of a board of directors or similar management or governing body, CEO, president, CFO, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

What If I'm Employed as an Adjunct Faculty Member at an Educational Institution That Is an Attest Client?

This is the one and only exception to the prohibition of being employed at an attest client. Although being employed by a client as an adjunct faculty member still raises threats to independence, when certain specified safeguards are in place, threats can be reduced to an acceptable level and independence maintained. The specific safeguards that a partner or professional employee must ensure are all in place is that they not

- be in a key position at the educational institution.
- participate on the attest engagement team.
- be an individual in a position to influence the attest engagement.
- participate in any employee benefit plans sponsored by the educational institution, unless participation is required.
- assume any management responsibilities or set policies for the educational institution.

Applying the Rules—Network Firms

What Is a Network Firm?

CPA firms frequently form associations with other firms and entities and cooperate with them to enhance their capabilities to provide professional services. On occasion, such cooperation creates the appearance that firms are closely aligned or connected. Such appearance exists when one or more of the following characteristics are present:

- The use of a common brand name (including common initials) as part of the firm name
- Common control (as defined by accounting principles generally accepted in the United States of America) among the firms through ownership, management, or other means
- Profits or costs, excluding costs of operating the association; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the firm
- Common business strategy that involves ongoing collaboration among the firms whereby the firms are responsible for implementing the association's strategy and are held accountable for performance pursuant to that strategy
- Significant part of professional resources
- Common quality control policies and procedures that firms are required to implement and that are monitored by the association

When a firm participates in such an association, and one or more of the preceding characteristics are present, the firm is considered a network firm. Any entity the firm controls by itself or through one or more of its owners is also considered a network firm. In addition, any entity that can control the firm or that the firm is under common control with would also be considered a network firm.

It is possible that not all firms in the association will meet one of the preceding characteristics. In such situations, only the subset of firms that meet one or more of the characteristics would be considered network firms.

How Do I Apply the Network Firm Rules?

Interpretation No. 101-17, "Networks and Network Firms," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .19), explains that when your firm is considered a network firm, your firm is required to remain independent of other network firm's audit and review clients and vice versa. Thus, a network firm may provide audit or review services for a client only insofar as other network firms are independent of the client. For example, other network firms could not provide prohibited nonattest services (that is, services that would impair independence under Interpretation No. 101-3, "Nonattest Services," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .05), for that client or have any prohibited relationships, such as investments by the firm in the client or loans to or from that client. For all other attest clients, members of network firms should consider any threats the firm knows or has reason to believe may be created by network firm interests and relationships. If those threats are not at an acceptable level, the members should apply safeguards to eliminate the threats or reduce them to an acceptable level.

When determining if a network exists, the SEC would look at all the facts and circumstances, especially how the firms treat one another when referring audit work (that is, do they place reliance on the work received by another firm, or do they treat the work the same as if an unaffiliated firm performed the work). At the SEC/PCAOB conference on December 10, 2007, it was noted that the SEC staff continue to follow the guidance issued in the SEC's January 2001 independence rule-making regarding its definitions of *firm* and *affiliate*, meaning staff will consider specific facts and circumstances, including the following:

- Does the primary auditor refer to another network firm in his or her audit opinion?
- Do the firms have common ownership, profit-sharing, or cost-sharing agreements?
- Do the firms share management, have a common brand name, or use shared professional resources?
- Do the firms have common quality control policies and procedures?

When Are the Rules Effective?

This guidance is effective for engagements covering periods beginning on or after July 1, 2011.

Applying the Rules—Family Members

When Is My Family Subject to the Rules?[9]

If you are a covered member with respect to a client, members of your immediate family (your spouse or equivalent and dependents) generally must follow the same rules that you follow. For example, your spouse's investments must be investments that you could own under the rules. This rule applies even if your spouse keeps the investments in his or her own name or with a different broker.

This general rule has the following exceptions:

1. Your immediate family member's employment with a client would not impair your firm's independence, provided he or she is not in a key position.
2. Immediate family members in permitted employment positions may participate in certain employee benefit plans that are attest clients or sponsored by an attest client, provided the plan is offered to all employees in comparable positions, and the immediate family member does not serve in a position of governance for the plan or have the ability to supervise or participate in the plan's investment decisions or selection of investment options.
3. Immediate family members of certain covered members may invest in a client through an employee benefit plan (for example, retirement or savings account), provided the immediate family member has no other investment options available for selection and, when such option becomes available, the immediate family member selects the option and disposes of any direct or material indirect financial interest in the attest client.
4. Immediate family members in permitted employment positions of certain covered members may participate in share-based compensation arrangements and nonqualified deferred compensation plans, provided certain safeguards are implemented.
5. The covered members whose families may invest or participate in the plans described in items (3) and (4) are
   a. partners and managers who provide only nonattest services to the client.
   b. partners who are covered members only because they practice in the same office where the client's lead attest partner practices in connection with the engagement.

[9] This guidance was updated by the Professional Ethics Executive Committee and is effective on June 1, 2011. Early application is permitted.

At no time may any direct or material indirect financial interests in an attest client permitted by the preceding exceptions exceed five percent of the attest client's outstanding equity securities or other ownership interests.

The SEC rules concerning holding unexercised stock options require the immediate family member to exercise or forfeit vested stock options as soon as the closing market price of the underlying stock equals or exceeds the exercise price. The AICPA rule recognizes that a privately held entity may not have a ready market for its shares or that thinly traded securities may have volatile markets. Therefore, the triggering event requiring an immediate family member to exercise his or her vested stock options occurs when the market price of the underlying stock equals or exceeds the exercise price for 10 consecutive days.

Alternatively, the SEC's rules concerning employee stock ownership plans (ESOPs) are more restrictive than the AICPA rules in that the immediate family member must dispose of the publicly traded shares received as soon as possible. Because the AICPA rules deal exclusively with private sector securities, it is possible that when the immediate family member receives shares from an ESOP, he or she may not be able to dispose of the shares because there is not a ready market for the shares. Accordingly, the AICPA rules allow the immediate family member to require the employee to exercise his or her put option for the employer to repurchase the shares as soon as permitted by the ESOP terms. If the employer does not pay for the repurchase shares within 30 days, the repurchase obligation must be immaterial to the covered member during the payout period.

What About My Other Close Relatives?

The close relatives (siblings, parents, and nondependent children) of most covered members are subject to some employment and financial restrictions. Your close relative's employment by a client in a key position impairs independence, except for covered members who provide only nonattest services to a client.

Rules pertaining to your close relatives' financial interests differ depending on why you are considered a covered member:

- If you are a covered member because you participate on the client's attest engagement team, your independence would be considered to be impaired if you are aware that your close relative has a financial interest in the client that either
  - — was material to your relative's net worth or
  - — enables the relative to exercise significant influence over the client.
- If you are a covered member because you are able to influence the client's attest engagement or are a partner in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that
  - — is material to your relative's net worth and
  - — enables your relative to exercise significant influence over the client.

Under SEC rules, your close family members include your spouse (or equivalent) and dependents, your parents, nondependent children, and siblings. If you are a covered person, your independence is affected if your close family member

- has an accounting role or financial reporting oversight role with the SEC audit client (for example, the family member is a treasurer, CFO, accounting supervisor, or controller) or
- owns more than five percent of a client's equity securities or controls the client.

In addition, independence is considered to be impaired if any partner's close family member controls an SEC audit client.

Financial Relationships

When Do My (or My Family's) Financial Interests Impair Independence?

This section discusses various types of financial relationships and how they affect independence. Although this section focuses on how these rules apply to you and your family, keep in mind that your firm also is subject to the financial relationship rules (because firms are included in the AICPA definition of *covered member*).

As a covered member, you (and your spouse or equivalent and dependents) are not permitted to have

- a direct financial interest in that client, regardless of how immaterial it would be to your net worth.
- a material indirect financial interest in that client.

 Note: The AICPA Code does not define, or otherwise provide, guidance on determining materiality. In determining materiality, you should apply professional judgment to all relevant facts and circumstances and refer to applicable guidance in the professional literature. Both qualitative and quantitative factors should be considered.

In addition, if you commit to acquire a direct or material indirect financial interest in a client, your independence would be impaired. For example, if you sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

Examples of financial interests include shares of stock; mutual fund shares; debt security issued by an entity; partnership units; stock rights; options or warrants to acquire an interest in a client; or rights of participation, such as puts, calls, or straddles.

The following types of financial interests are *direct financial interests*:

- Owned by you directly
- Under your control
- Beneficially owned[10] by you through an investment vehicle, estate, trust, or other intermediary if you can either
    - — control the intermediary or
    - — have the authority to supervise or participate in the intermediary's investment decisions

For example, if you invest in a participant-directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest in the investments held in your account.

You also have a direct financial interest in a client if you have a financial interest in a client through one of the following:

- A partnership, if you are a general partner
- A Section 529 savings plan, if you are the account owner
- An estate, if you serve as an executor and meet certain other criteria
- A trust, if you serve as the trustee and meet certain other criteria

For example, suppose you are a covered member with respect to ABC Co., and you are also a general partner of XYZ Partnership. XYZ Partnership owns shares in ABC Co. Under the independence rules, you would be deemed to have a direct financial interest in ABC Co. that would impair your independence, regardless of materiality.

[10] A financial interest is beneficially owned if an individual or entity is not the record owner of the interest but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or the disposition of the interest or to receive the economic benefits of the ownership of the interest.

An indirect financial interest arises if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary when you can neither control the intermediary nor have the authority to supervise or participate in the intermediary's investment decisions.

For example, if you invest in a defined contribution plan that is not participant-directed and you have no authority to supervise or participate in the plan's investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments, in addition to a direct financial interest in the plan.

> ***Note:*** Interpretation No. 101-15, "Financial Relationships," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .17), provides extensive examples of various types of financial interests and whether they should be considered to be direct or indirect financial interests, including investments in mutual funds, retirement and savings plans, Section 529 plans, trusts, partnerships, and insurance products.

The SEC classifies your investment in an SEC audit client held through another entity (the intermediary) as direct if either of the following is true:

- You participate in the intermediary's investment decisions or have control over them.
- The investment in the client by the intermediary (which is not a diversified mutual fund) represents 20 percent or more of the value of its total investments.

If neither of the preceding applies, your investment in an SEC audit client through another entity would normally be considered to be an indirect financial interest in that client.

What If My Immediate Family or I Receive a Financial Interest as a Result of an Inheritance or a Gift?

If, due to an unexpected event, you or members of your immediate family receive a financial interest in an attest client that would impair your independence, you may qualify under an exemption in the rules if you meet the following criteria:

- The financial interest was unsolicited.
- You dispose of the interest as soon as practicable, but no later than 30 days after you become aware of it and have the right to dispose.
- If you do not have the right to dispose of the interest (for example, as in the case of stock options or restricted stock), you do not participate in the attest engagement for the client.

What Are the Rules That Apply to My Mutual Fund Investments (and Those of My Family) If My Firm Audits Those Mutual Funds?

If you are a covered member with respect to a mutual fund attest client of your firm, and you or your immediate family own shares in the fund, you have a direct financial interest in the fund client.

The SEC rules also prohibit the firm and covered persons and their immediate family members from having any financial interest in an entity (even one that is not a client) that is part of an investment company complex that includes an SEC audit client.

Which Rules Pertain to My Mutual Fund Investments (and Those of My Family) If My Firm Audits Companies Held in Those Mutual Funds?

Financial interests that you and your immediate family have in clients through a mutual fund are considered to be indirect financial interests in those clients unless the fund is a diversified mutual fund.

If a mutual fund is diversified, and you or your immediate family, or both, own five percent or less of its outstanding shares, the fund's holdings in clients for which you are a covered person will not be considered material indirect financial interests in those clients. Thus, you would be relieved of the burden of having to monitor whether, and to what degree, the fund invests in audit clients for which you are a covered person.

If the fund is not diversified or you or your family, or both, own more than five percent of the fund's equity, you should treat the fund's holdings as indirect financial interests.

For example, suppose ABC Mutual Fund, a diversified mutual fund, owns shares in a client, XYZ, and

- ABC Mutual Fund's net assets are $10 million;
- your shares in ABC Mutual Fund are worth $50,000;
- ABC Mutual Fund has 10 percent of its assets invested in XYZ; and
- your indirect financial interest in XYZ is $5,000 ($50,000 x 0.10).

If $5,000 is material to your net worth, independence would be considered to be impaired.

May I Have a Joint Closely Held Investment With a Client?

As a covered member, if you or the client, individually or collectively, controls an investment, that investment is considered to be a joint closely held investment. If this joint closely held investment is material to your net worth, independence would be considered to be impaired. In this rule, the term *client* includes certain persons associated with the client, such as officers, directors, or owners who are able to exercise significant influence over the client.

The SEC rules prohibit you and your immediate family from having a joint business venture with an SEC audit client or persons associated with the client in a decision-making capacity (meaning officers, directors, or substantial shareholders), regardless of whether the venture is material to your net worth. The SEC believes that these joint ventures, regardless of whether they are material, cause the client and audit firm to have mutuality of interests, which impairs independence.

May My Family or I Borrow Money From, or Lend Money to, a Client?

If you are a covered member with respect to an attest client, you and your immediate family may not have a loan to or from

- the client.
- an officer or director of the client.
- an individual holding 10 percent or more of the client's outstanding equity securities (or other ownership interests).

Certain exceptions affect this rule. First, specific loans exist that covered members are permitted to have from financial institution attest clients, including

- car loans and leases collateralized by the vehicle.
- credit card and overdraft reserve account balances that are kept current and do not exceed $10,000 (by payment due date, including any grace period).
- passbook loans fully collateralized by cash deposits at the same financial institution.
- loans fully collateralized by an insurance policy.

In addition, if you have a loan from a client financial institution (for example, a bank) that meets certain criteria, your loan may be grandfathered (that is, you may be allowed to keep it). For your loan to be grandfathered, you must have obtained it under normal lending procedures, terms, and requirements. The following loans may be grandfathered:

- Home mortgages
- Other secured loans
- Unsecured loans that are immaterial to your net worth

Generally speaking, a loan may be grandfathered if you obtained it before

- you became a covered member with respect to the client.
- the financial institution became a client.
- the client acquired the loan.

To maintain your loan's grandfathered status, you must keep the loan current (that is, make timely payments according to the loan agreement). Also, you cannot renew or renegotiate the terms of the loan (for example, the interest rate or formula) unless the change was part of the original agreement (for example, an adjustable rate mortgage).

> The SEC rules differ from the AICPA rules in that secured loans (other than a mortgage on your primary residence) and immaterial unsecured loans may not be grandfathered.

May I Have a Brokerage Account With a Client?

The AICPA rules indicate that for independence to be maintained, a covered member whose assets are held by a broker-dealer client must not receive any preferential treatment or terms, and any assets that are subject to risk of loss must be immaterial to the covered member's net worth. In addition, margin accounts may be subject to the preceding loan rules.[11]

> Under the SEC rules, you may have a brokerage account with an SEC audit client if your account (1) only holds cash or securities and (2) is fully insured by the Securities Investor Protection Corporation.

May I Have a Bank Account With a Client?

As a covered member, you may have a bank account with a client financial institution (for example, checking, savings, money market accounts, and certificates of deposit) if your deposits are fully insured by state or federal deposit insurance agencies or if uninsured amounts are not material to your net worth.[12]

> The SEC prohibits covered persons and their immediate families from having bank account balances with an SEC audit client in excess of Federal Deposit Insurance Corporation (FDIC) insurance limits. That is, deposits in excess of FDIC limits are considered to impair independence even if the amounts are immaterial to you and your family.[13]

May I Have an Insurance Policy With a Client?

The AICPA rules[14] indicate that to maintain independence, a covered member must not receive any preferential treatment or terms when purchasing an insurance policy from a client. If the policy has an investment option, the financial interest rules must be applied.

> The SEC prohibits covered persons and their immediate family members from owning an individual insurance policy issued by an SEC audit client unless both of the following criteria are met:
>
> - He or she obtained the policy before the professional became a covered person.
> - The likelihood of the insurer becoming insolvent is remote.

May I Give Gifts or Entertainment to, or Accept Gifts or Entertainment From, a Client?

Ethics Ruling No. 114, "Acceptance or Offering of Gifts and Entertainment to or From an Attest Client," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, ET sec. 191 par. .228–.229), addresses the exchange of gifts and entertainment among covered members, the attest

[11] See the question, "May My Family or I Borrow Money From, or Lend Money to, a Client?" in this section.

[12] Both AICPA and SEC rules permit a practical exception for firms that maintain deposits exceeding insured limits when the likelihood of the financial institution experiencing financial difficulties is considered remote.

[13] The SEC treats money market funds (as opposed to money market accounts) as mutual funds for the purposes of its rules. Also see Rule 2-01(c)(1)(B).

[14] The guidance is found in the "Insurance Products" section of Interpretation No. 101-15, "Financial Relationships," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .17).

client, and certain persons associated with the client (for example, persons in key positions and persons owning 10 percent or more of the client's outstanding equity securities or other ownership interests).

Independence is impaired if the firm, a member of the attest engagement team, or a person able to influence the engagement accepts a gift that is not clearly insignificant.

A covered member may give a gift to persons associated with the client and not impair independence if the gift is reasonable in the circumstances. In addition, covered members may give or receive entertainment, provided it was reasonable in the circumstances.

Ethics Ruling No. 113, "Acceptance or Offering of Gifts or Entertainment," of ET section 191 (AICPA, *Professional Standards*, ET sec. 191 par. .226–.227), addresses the broader issue of integrity and objectivity when partners, professionals, or their firms exchange gifts or entertainment with clients or persons associated with clients. Generally, gifts are differentiated from entertainment by whether the client participates in the activity with the firm member (for example, giving tickets to a sporting event for the client to use would be considered a gift versus attending the event with the client, which would be considered entertainment).[15]

Relevant factors in determining reasonableness include the event or occasion (if any) giving rise to the gift or entertainment, cost or value, frequency, whether business was conducted, and who participated.

Business Relationships

Which Business Relationships With a Client Impair Independence?

As a partner or professional employee of your firm, independence would be considered to be impaired if you entered into certain business relationships with an attest client of the firm. Accordingly, you may not serve a client as any of the following:

- Employee, director, officer, or in any management capacity
- Promoter, underwriter, or voting trustee
- Stock transfer or escrow agent
- General counsel (or equivalent)
- Trustee for a client's pension or profit-sharing trust

In essence, any time you are able to make management decisions on behalf of a client or exercise authority over a client's operations or business affairs, independence is impaired.

Your independence is considered impaired even if you were a volunteer board member because you would be part of the client's governing body and, therefore, would be able to participate in the client's management decisions.

Two possible exceptions apply to this rule:

- If you are an honorary director or trustee for a client that is a nonprofit charitable, civic, or religious organization, you may hold such position with a client if
  - your position is purely honorary,
  - you do not vote or participate in managing the organization, or
  - your position is clearly identified as honorary in any internal or external correspondence.
- In addition, you may serve on a client's advisory board if all the following criteria are met:
  - The board's function is purely advisory.[16]
  - The board does not appear to make decisions for the client.

[15] See www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Gifts_Basis_Document.pdf.

[16] When evaluating your independence under this rule, you should examine the applicable board or committee charter to determine whether it is consistent with this ethics ruling.

— The advisory board and any decision-making boards are separate and distinct bodies.

— Common membership between the advisory board and any decision-making groups is minimal.

The SEC prohibits direct or material indirect business relationships with an SEC audit client (or persons associated with a client), except when the firm is acting as a consumer in the ordinary course of business (for example, purchasing goods or services from a client at normal commercial terms, and these goods or services will be consumed by the firm). Examples of prohibited business relationships include joint business ventures, limited partnership agreements, and certain leasing interests.

Nonattest Services

Which Rules Describe the Nonattest Services That My Firm and I May or May Not Provide to Attest Clients?

The term *nonattest services* includes accounting, tax, and consulting services that are not part of an attest engagement.[17] Nonattest services specifically addressed in the rules are the following:

- Bookkeeping services
- Nontax disbursement services
- Internal audit assistance services
- Benefit plan administration services
- Investment advisory or management services
- Tax compliance services
- Corporate finance consulting or advisory services
- Appraisal, valuation, or actuarial services
- Executive or employee search services
- Business risk consulting services
- Information systems design, installation, or integration services
- Forensic accounting services

In addition to considering the general standard and four guiding principles, the SEC rules generally prohibit a CPA from providing the following services to an SEC audit client during the audit and professional engagement period:

- Bookkeeping and other services related to the client's accounting records or financial statements
- Financial information systems design and implementation
- Appraisal or valuation services
- Actuarial services
- Internal audit outsourcing
- Management functions
- Human resources
- Broker-dealer, investment adviser, or investment banking
- Legal services
- Expert services unrelated to the audit

[17] Defined in the AICPA Code of Professional Conduct, an *attest engagement* is one that requires independence under AICPA professional standards; for example, audits and reviews of financial statements or agreed-upon procedures performed under the attestation standards are considered attest engagements.

Under PCAOB rules, the following types of services also are subject to significant restrictions if the auditor provides them to an issuer during the audit and professional engagement period:

- Aggressive or confidential tax transactions
- Personal tax services provided to persons in financial reporting oversight roles

If your firm performs nonattest services for an attest client, the independence rules impose limits on the nature and scope of the services that your firm may provide. In other words, the extent to which your firm may perform certain tasks will be limited by the rules. Further, certain services will be prohibited in total (for example, serving as a client's general counsel). These rules apply during the period of the professional engagement and the period covered by the financial statements (to which the attest services relate). However, if the member provided the entity with prohibited nonattest services prior to the entity becoming an attest client, independence would not be impaired if the prohibited nonattest services related to periods prior to the periods covered by the financial statements the member is engaged to audit, and those prior period financial statements were audited by another firm (or, in the case of a review engagement, reviewed or audited by another firm).

In August 2007, the SEC updated its frequently asked questions (FAQ) document, *Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence—Frequently Asked Questions*. FAQ No. 7 under the "Prohibited and Non-audit Services" section addresses the question of whether a successor auditor who performed one of the preceding services during the audit period (period covered by the financial statements) would be independent of an SEC audit client. The FAQ states that if the services (*a*) relate solely to the prior period audited by the predecessor auditor, and (*b*) were performed before the successor auditor was engaged to audit the current audit period, independence would not be impaired.

This section does not discuss each of these services but, rather, focuses on a few for purposes of illustration. To see the full context of the rules, see Interpretation No. 101-3 and SEC Rule 2-01(c)(4), "Non-audit services." You also are encouraged to review the *Frequently Asked Questions: Performance of the Nonattest Services* developed by the Professional Ethics Division and the "Prohibited and Non-audit Services" section of *Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence—Frequently Asked Questions* developed by the SEC's Office of the Chief Accountant.

The AICPA rules require a member to comply with more restrictive independence provisions, if applicable, of certain regulators, such as state boards of accountancy and the SEC, GAO, and DOL.

SEC and PCAOB rules require independence of an issuer that is an audit client and various affiliated entities of the client.[18]

> ***Note:*** SEC rules also require a client's audit committee (or equivalent) to preapprove all audit and nonaudit services provided by the firm to an issuer and the issuer's consolidated entities. Proposals to provide tax or internal control-related services are subject to more extensive audit committee preapproval requirements under PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*, and Rule 3525, *Audit Committee Pre-Approval of Non-audit Services Related to Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board).

PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), superseded the PCAOB's interim standard, ISB Standard No. 1, *Independence Discussions with Audit Committees* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and its interpretations. Before accepting a new audit engagement and annually thereafter, the auditor must describe in writing to the issuer's audit committee all relationships between the auditor and the client (including affiliates of both) that could reasonably be thought to bear on independence, discuss these matters with the audit committee, and document the substance of that discussion (effective September 30, 2008).

[18] See Rule 2-01(f)(4) and (6).

AICPA General Requirements

General Requirement 1

One of the key principles underlying the AICPA rules on nonattest services is that you may not assume management responsibilities or even appear to assume management responsibilities. Management responsibilities involve leading and directing an entity, including significant decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources. Examples of management responsibilities include such activities as

- setting policies or strategic direction for the client.
- directing or accepting responsibility for the actions of the client's employees, except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards.
- authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of a client or having the authority to do so.
- preparing source documents in electronic or other form evidencing the occurrence of a transaction. *Source documents* are the documents upon which evidence of an accounting transaction are initially recorded and are often followed by the creation of many additional records and reports that do not, however, qualify as initial recording. Examples of source documents are purchase orders, payroll time cards, and customer orders.
- having custody of client assets.
- deciding which recommendations of the member or other third parties to implement or prioritize.
- reporting to those charged with governance on behalf of management.
- serving as the client's stock transfer or escrow agent, registrar, general counsel, or its equivalent.
- accepting responsibility for management of a client's project.
- accepting responsibility for preparation and fair presentation of the client's financial statements in accordance with the applicable financial reporting framework.
- accepting responsibility for designing, implementing, or maintaining internal control.
- performing ongoing evaluations of the client's internal control as part of its monitoring activities.

General Requirement 2

To help ensure compliance with the first general requirement, the second requirement states that the client must agree to assume certain responsibilities related to the nonattest services engagement. So, prior to agreeing to perform any nonattest services for the client, the member must obtain the client's agreement that the client will

- assume all management responsibilities.
- oversee the service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and experience. The member should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them but is not required to possess the expertise to perform or reperform the services.
- evaluate the adequacy and results of the services performed.
- accept responsibility for the results of the services.

With regard to the preceding list, the member should be satisfied that the client designee will be able to meet this criteria, make informed judgment on the results of the nonattest services, and be responsible for making all significant judgments and decisions that are the proper responsibility of management. The client also must be willing to commit the time and resources needed for the designee to fulfill these duties.

General Requirement 3

Before performing nonattest services, the firm should establish and document its understanding with the client regarding the following:

- Objectives of the engagement
- Services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

The firm should document the understanding in the engagement letter, audit planning memo, or other internal firm file.

> ***Note:*** Routine activities (for example, assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements) that are part of the normal member-client relationship are exempt from the second and third general requirements.

What Are the Rules Concerning Performing Bookkeeping Services for a Client?

The AICPA independence rules prohibit members from assuming management responsibilities in all circumstances. Accordingly, a member may provide bookkeeping services if the client oversees the services and, among other things, performs all management responsibilities in connection with the services. For example, if a member is engaged to provide bookkeeping services that will result in a set of financial statements, the client must

- approve all account classifications.
- provide source documents to the member so that the member can prepare journal entries.
- take responsibility for the results of the member's services (for example, financial statements).

> ***Note:*** Proposing adjusting entries to a client's financial statements as a part of the member's audit, review, or compilation services is considered a normal part of those engagements and would not be considered the performance of a nonattest service subject to the general provisions of Interpretation No. 101-3, provided the client reviews these entries, understands the impact on its financial statements, and records any adjustments identified by the member that the client believes appropriate.

Because of self-audit concerns, performing any type of bookkeeping service for an SEC audit client is considered to impair independence under SEC rules unless it is reasonable to expect that the results of the auditor's services will not be subject to the firm's audit procedures. The SEC considers there to be a rebuttable presumption that the results of these services would be subject to audit procedures; therefore, the firm must overcome the presumption to perform the service.

This presumption of self-audit also applies to (1) financial information design and implementation; (2) appraisals, valuations, fairness opinions, or contribution-in-kind reports; (3) actuarial-related advisory services; and (4) internal audit outsourcing.

May My Firm Provide Internal Audit Assistance to a Client?

To perform internal audit assistance for a client and maintain independence, your firm may not, in effect, manage the internal audit activities of the client. For example, you and your firm may not

- make decisions on the client's behalf.
- report to the client's governing body.

To maintain independence, the client must

- designate an individual or individuals who possess suitable skill, knowledge, and experience (preferably within senior management) to oversee the internal audit function.

- determine the scope, risk, and frequency of internal audit activities.
- evaluate the findings and results of internal audit activities.
- evaluate the adequacy of the audit procedures performed and related findings.

Internal audit services provided to an SEC audit client impair independence unless it is reasonable to expect that the results of the auditor's services would not be subject to the firm's audit procedures.

Note: For entities regulated by the FDIC or other banking agencies, see www.fdic.gov/news/news/financial/2009/fil09033.html.

May My Firm Manage a Project For a Client?

Responsibility for client projects, including whether to proceed with a project, is management's responsibility. Accordingly, if a member accepts responsibility for management of a client's project, then the member's independence would be impaired even if the project did not affect the client's financial statements.

However, if the member's services were limited to providing assistance, advice, suggestions, or recommendations regarding matters that are within his or her areas of knowledge or experience, independence would not be impaired.

May My Firm Provide Valuation, Appraisal, or Actuarial Services to a Client?

Your firm may not provide valuation, appraisal, or actuarial services to a client if

- the results of the service would be material to the client's financial statements, and
- the service involves a significant amount of subjectivity.

For instance, your firm may not perform a valuation in connection with a business combination that would have a material effect on a client's financial statements because that service involves significant subjectivity (for example, setting the assumptions and selecting and applying the valuation methodology).

Two limited exceptions apply to this rule. First, valuation, appraisal, or actuarial services performed for nonfinancial statement purposes may be provided if they otherwise meet the rule's general requirements. (For example, the client assigns an individual who is in a position to make an informed judgment on, and accept responsibility for, the results of the service to oversee the service.) Also, your firm may provide an actuarial valuation of a client's pension or postretirement liabilities because the results of the valuation would be reasonably consistent, regardless of who performs the valuation.

The SEC prohibits your firm from providing valuation, appraisal, or any service involving a fairness opinion or contribution-in-kind report[19] to an SEC audit client unless it is reasonable to expect that your firm would not audit the results of those services.

In August 2008, the staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of an FAQ) on the question of whether, under Interpretation No. 101-3, members could assist an attest client in applying Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 805, *Business Combinations*, or 350, *Intangibles—Goodwill and Other*, while maintaining independence. Specifically, the FAQ addresses whether the following services would be considered to impair independence:

- Providing the client advice on valuation methodologies and assumptions needed to perform the valuation
- Providing advice on valuation templates, software, or other tools that allow the client to determine an appropriate value for acquired assets, goodwill, contingent consideration, and so on

[19] Per the SEC, fairness opinions and contribution-in-kind reports are opinions and reports in which your firm provides its opinion on the adequacy of consideration in a transaction.

May My Firm Provide Investment Advisory Services to a Client?

Here are examples of what you and your firm may do under the AICPA rules, provided the general requirements are met:

- Make recommendations to a client about the allocation of funds to various asset classes
- Analyze investment performance

However, the AICPA rules also indicate that you and your firm may not do the following:

- Make investment decisions for the client
- Execute investment transactions
- Take custody of a client's assets

May My Firm Design or Implement an Information System for a Client?

Your firm may not design or develop a client's financial information system or make more than insignificant modifications to the source code underlying such a system. In addition, operating a client's local area network is prohibited.

Your firm may install an accounting software package for a client, including helping the client set up a chart of accounts and financial statement format. Your firm may perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings, as specified by management. Your firm also may provide training to the client's employees on how to use an information system. Your firm may not, however, supervise the client's employees in their day-to-day use of the system because that activity is a management function.

Your firm is not precluded from designing, implementing, integrating, or installing an information system that is unrelated to the client's financial reporting process.[20]

SEC rules prohibit your firm from providing any service related to an SEC audit client's financial information system design or implementation unless the results of your firm's services would not be subject to audit procedures during an audit of the client's financial statements. Your firm may do either of the following:

- Evaluate internal controls of a financial information system as it is being designed, implemented, or operated for the client by another service provider
- Make recommendations on internal control matters to management in connection with a system design and implementation project being performed by another service provider

Note: If your audit client is an issuer, your firm must obtain preapproval for these and other internal control-related services, in accordance with PCAOB Rule 3525.

May My Firm Provide a Client With Training Services?

The staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of an FAQ) on the question of whether a member's independence would be impaired if he or she provided training to a client that is implementing changes to its financial reporting system or process. The FAQ concludes that a member's independence would not be impaired if the client personnel are provided with a general understanding of the financial reporting system or process. It goes on to explain that if client personnel already have a general understanding, the member may provide more specific training to client personnel on how the system or process applies to the client's specific circumstances. It cautions members that they should ensure that the training does not involve supervising client personnel in either the implementation or daily operation of the financial system or process or result in the member performing other management responsibilities, such as making operational decisions or implementing the internal controls necessary for the system or process to run effectively.

[20] Frequently asked questions are available to assist members in understanding and implementing the new information technology services provisions and may be obtained at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.

Fee Issues

What Types of Fee Arrangements Between My Firm and a Client Are Prohibited?

Two types of fee arrangements—contingent fees and commissions—are prohibited if the arrangement involves certain attest clients, even though the fee is not related to an attest service.

A contingent fee is an arrangement whereby no fee is charged unless a specified result is attained, or the amount of the fee depends on the results of your firm's services. Some examples of contingent fees are as follows:

- Your firm receives a "finder's fee" for helping a client locate a buyer for one of your client's assets.
- Your firm performs a consulting engagement to decrease a client's operating costs. The fee is based on a percentage of the cost reduction the client achieves as a result of your service.

The following are exceptions:

- Fees fixed by a court or other public authority
- In tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies

A *commission* is any compensation paid to you or your firm for recommending or referring a third party's product or service to a client or recommending or referring a client's product or service to a third party.

The following are examples of commissions:

- If you or your firm refers a client to a financial planning firm that pays you a commission for the referral
- If you or your firm sells accounting software to a client and receives a percentage of the sales price (a commission) from a software company
- If you or your firm refers a nonclient to an insurance company client that pays you a percentage of any premiums subsequently received (a commission) from the nonclient

Commissions or contingent fee arrangements with a client are not allowed if your firm also provides one of the following services to a client:

- An audit of financial statements
- A review of financial statements
- A compilation of financial statements if a third party (for example, a bank or an investor) will rely on the financial statements, and the report does not disclose a lack of independence
- An examination of prospective financial statements

You may have commission and contingent fee arrangements with persons associated with a client, such as officers, directors, and principal shareholders, or with a benefit plan that is sponsored by a client (that is, the plan itself is not an attest client). For example, you may receive a commission from a nonclient insurer if you refer an officer of an attest client to the insurer, and the officer purchases a policy. Even though this situation is permitted, you are still required to tell the officer that you received a commission for making the referral.

> ***Note:*** State boards of accountancy and state societies also may have more restrictive regulations regarding fee arrangements, as well as specific disclosure requirements.

PCAOB Rule 3521, *Contingent Fees* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), prohibits you and your firm from providing any service or product to an SEC audit client for a contingent fee or commission or receiving from the audit client, directly or indirectly, a contingent fee or commission. Although the PCAOB's definition of *contingent fees* was adapted from the SEC's definition, the PCAOB rule eliminated the exception for fees in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. In addition, the PCAOB rule specifically indicates that the contingent fees cannot be received directly or indirectly from an issuer that is an audit client.

When Are Referral Fees Permitted?

Rule 503, *Commissions and Referral Fees* (AICPA, *Professional Standards*, ET sec. 503 par. .01), provides an exception for referral fees for recommending or referring a CPA's services to another person or entity. That is, you may receive a fee for referring a CPA's services to any person or entity, or if you are a CPA, you may pay a fee to obtain a client. You must inform the client if you receive or pay a referral fee.

Is Independence Affected When a Client Owes the Firm Fees for Professional Services That the Firm Has Already Provided?

If a client owes your firm fees for services rendered more than one year ago, your firm's independence is considered impaired. It does not matter if the fees are related to attest services; what matters is that the client has an outstanding debt with the firm. This is the case even if the client has given you a note receivable for these fees.

The SEC generally expects payment of past due fees before an engagement has begun, although a short-term payment plan may be accepted if the SEC audit client has committed to pay the balance in full before the current year report is issued.[21]

Does Being Compensated for Selling Certain Services to Clients Affect My Independence?

The AICPA rules do not specifically address this issue.

The SEC prohibits audit partners from being directly compensated for selling nonattest services to issuers that are audit clients. The SEC believes that such financial incentives could threaten an audit partner's objectivity and that the appearance of independence could be affected by such compensation arrangements.[22]

The rule does not prevent an audit partner from sharing in profits of the audit practice or overall firm. It also does not preclude the firm from evaluating a partner based on factors related to the sale of nonaudit services to issuers (for example, the complexity of engagements or overall management of audit or nonaudit engagements).

Does It Matter If a Significant Proportion of My Firm's Fees Comes From a Particular Client?

The conceptual framework states that a financial self-interest threat may exist due to "excessive reliance on revenue from a single attest client." In addition, Rule 102 and ET section 55, *Article IV—Objectivity and Independence* (AICPA, *Professional Standards*), discuss in broad terms that members should be alert for relationships that could diminish their objectivity and independence in performing attest services. The significance of a client to a member (or his or her firm), measured in terms of fees, status, or other factors, may diminish a member's ability to be objective and maintain independence when performing attest services.

To address this issue, firms should consider implementing the following policies and procedures to identify and monitor significant clients to help mitigate possible threats to a member's objectivity and independence:

- Policies and procedures for identifying and monitoring significant client relationships, including the following:
  - Considering client significance in the planning stage of the engagement.
  - Basing the consideration of client significance on firm-specific criteria or factors that are applied on a facts and circumstances basis (see the "Factors to Consider in Identifying Significant Clients" section that follows).

[21] The exception generally has been applied only to engagements to audit a client's financial statements included in its annual report, not in a registration statement.

[22] Accounting firms with 10 or fewer partners and 5 or fewer audit clients that are *issuers*, as defined by the SEC, are exempt from this rule.

— Periodically monitoring the relationship. What constitutes periodic is a matter of judgment, but assessments of client significance that are performed at least annually can be effective in monitoring the relationship. During the course of such a review, a client previously deemed to be significant may cease to be significant. Likewise, clients not identified as significant could become significant whenever factors the firm considers relevant for identifying significant clients arise. (For example, additional services are contemplated.)

- Policies and procedures for helping mitigate possible threats to independence and objectivity, including the following:
  - — Assigning a second (or concurring) review partner who is not otherwise associated with the engagement and who practices in an office other than those who perform the attest engagement
  - — Subjecting the assignment of engagement personnel to approval by another partner or manager
  - — Periodically rotating engagement partners
  - — Subjecting significant client attest engagements to internal firm monitoring procedures
  - — Subjecting significant client attest engagements to preissuance or postissuance reviews or the firm's external peer review process

The most effective safeguards a firm can employ will vary significantly, depending on the size of the firm; the way the firm is structured (for example, whether highly centralized or departmentalized); and other factors. For example, smaller firms (particularly those with one office) tend to be simpler and less departmentalized than larger firms. Generally, their processes will be less formal and involve fewer people than those of larger firms. Further, the firms' managing partners may engage in frequent and direct communications with the firms' partners and professional staff on client matters and be personally involved in staff assignments. Larger firms draw from a sizeable and diverse talent pool. In those firms, partners who are not affiliated with the engagement (or client service office or business unit) can choose second (or concurring) review partners from outside the office performing the attest engagement. Midsized or regional firms may have aspects of both their smaller and larger counterparts, such as combining the ability to choose second review partners from an office other than the client service office while maintaining a relatively close connection to specific client relationships.

Factors to Consider in Identifying Significant Clients

The following are both qualitative and quantitative factors that can reveal a significant client:

- The size of the client in terms of the percentage of fees or the dollar amount of fees versus total revenue of the engagement partner, office, or practice unit of the firm[23]
- The significance of the client to the engagement partner, office, or practice unit of the firm in light of the following:
  - — The amount of time the partner, office, or practice unit devotes to the engagement
  - — The effect on the partner's stature within the firm due to his or her relationships with the client
  - — The manner in which the partner, office, or practice unit is compensated
  - — The effect that losing the client would have on the partner, office, or practice unit
- The importance of the client to the firm's growth strategies (for example, the firm is trying to gain entry into a particular industry)
- The stature of the client, which may enhance the firm's stature (for example, the firm is trying to gain entry into a particular industry)

[23] Assessing client significance at the business or practice unit level may be a more meaningful measure for firms that structure their practices along industry lines (such as healthcare or financial services).

- Whether the firm also provides services to related parties (for example, also provides professional services to affiliates or owners of the client)
- Whether the engagement is recurring

Judgment is necessary to determine whether a client is significant to the firm, office, practice unit, or partner of the firm. Firms will vary considerably in terms of the degree to which they consider some factors to be more pertinent than others. Gauges that relate to each relevant level within a firm (for example, firm, geographic region, office, or practice unit) may be useful but likely will be different for various levels within the firm.

In general, if a firm derives more than 15 percent of its total revenues from one SEC audit client or group of related clients, independence may be impaired because this may cause the firm to be overly dependent on the client or group of related clients.

Further Assistance

Where Can I Find Further Assistance With My Independence Questions?

This appendix does not address many subjects included in the AICPA rules. Readers are encouraged to view the online version of the code at www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx.

In addition, readers should refer to ET section 100-1, which can be found online at www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_100.aspx, in evaluating whether a specific circumstance that is not addressed in the AICPA Code would pose an unacceptable threat to independence.

As specific services and situations arise in practice, refer to the independence literature and consult with those responsible for independence in your firm. If you need further assistance researching your question, contact one of the following organizations for guidance.

The AICPA has a variety of resources for practitioners:

- For information about the AICPA's ethics standard-setting projects, exposure drafts, and meetings, go to www.aicpa.org/INTERESTAREAS/PROFESSIONALETHICS/COMMUNITY/Pages/community.aspx.
- For questions related to understanding the nonattest services rules, consult the *Background and Basis for Conclusions* document for nonattest services at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsNonAttestServices.doc.
- For resources related to applying the nonattest services rules, go to www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.
- For independence inquiries by phone, call 888.777.7077. Send e-mail inquiries to ethics@aicpa.org.
- The AICPA interactive CD-ROM course on independence, *Independence*, teaches the AICPA and SEC independence rules and qualifies for four hours of continuing professional education credits. Go to www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Ethics/PRDOVR~PC-739155HS/PC-739155HS.jsp.
- The PCPS Independence Toolkit, which includes the "Inadvertent Independence Violations Practice Tool" to assess the impact and determine appropriate next steps when an independence violation is identified. Go to www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/Resources/KeepingUp/Pages/PCPSIndependenceToolkit.aspx.
- The *2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid* will assist auditors performing audits in accordance with the 2011 revision to *Government Auditing Standards* (the 2011 Yellow Book) issued by the GAO in identifying and evaluating threats to independence for nonaudit services when considering whether to provide a nonaudit service. It will also assist auditors in applying the conceptual framework for independence contained in the 2011 Yellow Book (Yellow Book Conceptual Framework) and in complying with the Yellow Book's independence documentation requirements. Go to www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/AuditPracticeToolsAids/Pages/YellowBookAuditToolsandAids.aspx.

SEC resources are as follows:

- The SEC's January 2003 rules release is available at www.sec.gov/rules/final/33-8183.htm.
- Information for accountants, including independence, may be found online at the Office of the Chief Accountant at www.sec.gov/about/offices/oca/ocaprof.htm.
- Independence reference materials can be found on the SEC website at www.sec.gov/info/accountants/independref.shtml.
- U.S. Securities and Exchange Commission, Office of the Chief Accountant, 100 F Street, NE, Washington, DC 20549; 202.551.5300 (Phone); 202.772.9252 (Fax).

The PCAOB has a website at www.pcaobus.org. Rules can be found at www.pcaobus.org/Rules/Pages/default.aspx, and standards can be found at http://pcaobus.org/Standards/Pages/default.aspx.

GAO resources are as follows:

- Obtain the GAO Yellow Book requirements at www.gao.gov/yellowbook.
- Obtain the 2011 Yellow Book independence standards at www.gao.gov/govaud/iv2011gagas.pdf#page=29.
- Access a slide presentation on GAO independence standards at www.gao.gov/govaud/july2007slides.pdf.
- Direct inquiries should be sent to Michael Hrapsky, Senior Project Manager, *Government Auditing Standards*, at 202.512.9535 or e-mail yellowbook@gao.gov.

DOL resources are as follows:

- DOL Regulation 2509.75-9, *Interpretive Bulletin Relating to Guidelines on Independence of Accountant Retained by Employee Benefit Plan*. This regulation can be found at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=e46da7169dc9db98a57461c30d1115bf&rgn=div5&view=text&node=29:9.1.3.1.1&idno=29#29:9.1.3.1.1.0.10.9.
- Direct inquiries to the DOL at 1.866.4.USA.DOL.

Banking regulators' resources are as follows:

- Obtain the FDIC regulations, "Annual Independent Audits and Reporting Requirements" (Title 12 U.S. *Code of Federal Regulations* Part 363) at www.fdic.gov/regulations/laws/rules/2000-8500.html#fdic2000part3630.
- The following organizations comprise the Federal Financial Institutions Examination Council (FFIEC): the Board of Governors of the Federal Reserve System; the FDIC; the National Credit Union Administration; and the Office of the Comptroller of the Currency. The FFIEC issues financial institution letters (FILs) that are addressed to the CEOs of the financial institutions on the FIL's distribution list, generally FDIC-supervised institutions. FILs may announce new regulations and policies, new FDIC publications, and a variety of other matters of principal interest to those responsible for operating a bank or savings association. FILs have addressed auditor conduct (for example, internal audit outsourcing and use of indemnification clauses in engagement letters) in recent years and may apply to both public and nonpublic institutions. Additional information is available. Go to http://search.fdic.gov/search?access=p&output=xml_no_dtd&sort=date:D:L:d1&site=fils&ie=UTF-8&btnG=Search&client=fils&oe=UTF-8&proxystylesheet=fils&q=auditor+independence&ip=69.113.123.203&filter=p for additional information.

International Federation of Accountants (IFAC) resources are as follows:

- Information about the International Ethics Standards Board for Accountants (IESBA) can be found on the IFAC's website at www.ifac.org/Ethics/.
- The IESBA's *Code of Ethics for Professional Accountants* can be found at www.ifac.org/sites/default/files/publications/files/2012-IESBA-Handbook.pdf.

[*The next page is 9001.*]

AAM Section 9000
Auditors' Reports

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*

AICPA Requirements

.01 The AICPA issues Statements on Auditing Standards (SASs), including AU-C section 700, AU-C section 705, and AU-C section 706, that provide guidance on auditor's reports. In citing generally accepted auditing standards and their related interpretations, references use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate. Similarly, when citing attestation standards and their related interpretations, references use section numbers within the codification of currently effective Statements on Standards for Attestation Engagements and not the original statement number, as appropriate.

.02 Section 9100, "Comparative Financial Statements," provides guidance on developing the auditor's report in accordance with applicable AICPA professional standards, supplemented with best practice recommendations to ensure that practitioners issue the highest quality auditor's report for the particular circumstances of their engagements. Illustrative examples are provided so practitioners can easily apply the guidance. Additionally, subscriptions to *The Auditor's Report: Comprehensive Guidance and Examples* are available through the AICPA Store at www.cpa2biz.com. This online tool contains sample auditor's reports that can be downloaded for easy mark-up and customization. With its added automation, practitioners will save time and minimize the risk of omitting a crucial part of the report. This online tool contains all of the sample auditor's reports that are included in this section of the *Audit and Accounting Manual* and many more.

.03 The scope of this section does not include auditor's reports for engagements performed under standards issued by the Public Company Accounting Oversight Board.

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AAM Section 9010

Overview — Auditor's Report

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*
- AU-C section 708, *Consistency of Financial Statements*
- AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*
- AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole*
- AU-C section 730, *Required Supplementary Information*
- AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*
- AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*

.01 Requirements related to the form and content of auditor's reports are contained in AU-C section 700. This section is the base of the reporting standards. It maintains the auditors' responsibilities for reporting on financial statements as required by the extant standards in all significant respects. However, the form of the auditor's report does differ from the extant standards in that it

- requires the use of headings to highlight
  - — management's responsibility for the financial statements,
  - — the auditor's responsibility, and
  - — the auditor's opinion.
- describes management's and the auditor's responsibilities in greater detail.
- requires the city and state where the auditor practices to be stated.

.02 The clarified auditing standards related to auditor's reports continue to build upon the base established in AU-C section 700. AU-C section 705 contains guidance related to modifications to the opinion in the independent auditor's report. There are very few, if any, changes between the extant standards and the clarified SASs.

.03 AU-C section 706 introduces two new terms, *emphasis-of-matter* and *other-matter paragraphs*, replacing the term *explanatory paragraph*:

- An emphasis-of-matter paragraph is any paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements. Some emphasis-of-matter paragraphs are required by certain standards, whereas others are added at the discretion of the auditor, consistent with current practice. However, all such paragraphs are to be considered emphasis-of-matter paragraphs because they are intended to draw the users' attention to a particular matter that is appropriately presented or disclosed in the financial statements.

- An other-matter paragraph is a paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to the users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

Accordingly, the term *explanatory paragraph* is no longer a recognized element of the auditor's report in GAAS. Instead, additional communications in the auditor's report are labeled as either emphasis-of-matter or other-matter paragraphs. AU-C section 706 requires an emphasis-of-matter or other-matter paragraph to always follow the opinion paragraph and to be included in a separate section of the auditor's report under the heading "Emphasis of Matter" or "Other Matter," or other appropriate heading.

.04 The clarified standards continue to build upon the base reporting requirements established in AU-C section 700 in the following:

- AU-C section 708
- AU-C section 720
- AU-C section 725
- AU-C section 730

These sections address consistency of financial statements, as well as other information in documents containing audited financial statements. Reporting on supplementary information and required supplementary information is also addressed within these sections.

.05 An auditor reporting on financial statements prepared in accordance with special purpose frameworks will follow the requirements and guidance in AU-C section 800. The previous sections still apply, but this section addresses special considerations in the application of those AU-C sections to an audit of financial statements prepared in accordance with a special purpose framework, which is a cash, tax, regulatory, or contractual basis of accounting.

.06 An auditor is sometimes engaged to report on a single financial statement or on a specific element, account, or item of a financial statement. Requirements and guidance related to this reporting is contained in AU-C section 805. Again, AU-C sections 200–700 apply, and this section addresses special considerations in the application of those AU-C sections to these circumstances. In addition, if the financial statements are prepared in accordance with a special purpose framework, AU-C section 800 also applies to the audit.

.07 Readers should be aware of other clarified standards that may also affect the auditor's report.

.08 The following sections contain guidance and examples for a variety of reporting scenarios. Exhibit 9010-1 is a table that contains the required elements of an auditor's reports under the clarified standards. It lists exhibits that show appropriate wording based on the reporting circumstances. Not all exhibits are listed.

.09

Exhibit 9010-1 — Required Elements of an Auditor's Report

Section of the Auditor Report	*When Included in the Auditor's Report*	*What Changes in the Auditor's Report*	*Example*
Title	Always	• No changes	Exhibit 9020-1
Addressee	Always	• Who report is addressed to	Exhibit 9020-1
Introductory Paragraph	Always	• Financial statements presented • Period(s) covered by the financial statements	Exhibit 9020-1; Exhibit 9020-3; Exhibit 9020-4; Exhibit 9100-5
Management's Responsibility	Always	• No changes	Exhibit 9020-1
Auditor's Responsibility	Always	• Additional language required when reference is made to another auditor's report • Different language required when disclaiming an opinion or issuing a qualified or adverse opinion	Exhibit 9020-1
Basis for Modified Opinion	When report is modified	• Wording depends on circumstances	Exhibit 9100-7; Exhibit 9110-1
Auditor's Opinion	Always	• Wording depends on circumstances • Additional working required if making reference to another auditor's report • Financial statements presented • Period(s) covered by financial statements • Financial reporting framework (basis of accounting used)	Exhibit 9020-1; Exhibit 9100-7; Exhibit 9110-1
Emphasis-of-Matter	When required or elected by auditor	• Wording depends on circumstances	Exhibit 9100-8; Exhibit 9100-10
Other Matter	When required or elected by auditor	• Wording depends on circumstances	Exhibit 9100-2; Exhibit 9100-9; Exhibit 9100-10; Exhibit 9100-11

(continued)

Section of the Auditor Report	*When Included in the Auditor's Report*	*What Changes in the Auditor's Report*	*Example*
Restriction on Use	When required or elected by auditor	• Name of specified parties	
Signature	Always	• No changes	Exhibit 9020-1
Auditor's Address	Always	• No changes	Exhibit 9020-1
Date of the Auditor's Report	Always	• No changes	Exhibit 9020-1

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AAM Section 9020

Unmodified Opinions

This section contains the following reference from AICPA *Professional Standards*:

AU-C Section:

- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*

.01 The objectives of an auditor, as explained in paragraph .10 of AU-C section 700, are (1) to form an opinion on the financial statements based on an evaluation of the audit evidence obtained and (2) to express clearly that opinion on the financial statements through a written report that also describes the basis for that opinion.

.02 In order to meet the first objective of forming an opinion, the auditor should evaluate whether the financial statements are prepared, in all material respects, in accordance with the applicable reporting framework based on the evidence obtained. Paragraphs .15–.18 of AU-C section 700 describe that as part of this evaluation, the auditor should take into consideration whether sufficient appropriate evidence has been obtained, if uncorrected misstatements are material, individually or in the aggregate, and the following:

- Whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable reporting framework, considering the qualitative aspects of the entity's accounting practices, including possible bias in management's judgments
- Whether
  - — the financial statements adequately disclose the significant accounting policies,
  - — the accounting policies are consistent with the applicable reporting framework and are appropriate,
  - — management's accounting estimates are reasonable,
  - — the information in the financial statements is relevant, reliable, comparable, and understandable,
  - — the financial statements provide adequate disclosure, and
  - — the terminology used in the financial statements, including the title of each financial statement, is appropriate
- Whether the financial statements achieve fair presentation by considering the overall presentation, structure, and content of the financial statements and whether the financial statements, including related notes, represent the underlying transactions and events in a manner that achieves fair presentation
- Whether the financial statements adequately refer to or describe the applicable financial reporting framework

.03 Once the first objective, forming an opinion, is met, then the second objective, expressing the opinion, can be met. If the auditor concludes that the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework, the auditor should express an unmodified opinion. The guidance related to the basic form of the auditor's report resides in paragraphs .22–.41 of AU-C section 700 and is explained throughout the remainder of this section. The unmodified opinion should be in writing and include the following sections:

Title. The title should include the word "independent" to clearly indicate that it is the report of an independent auditor. The reference to independent affirms that the auditor has met all the relevant ethical requirements regarding independence.

Addressee. The auditor's report should be addressed to an appropriate addressee. This is normally those for whom the report is prepared. It may be addressed to the entity whose financial statements are being audited or those charged with governance. Occasionally, an auditor may be retained to audit the financial statements of an entity that is not a client; in such a case, the report may be addressed to the client and not to those charged with governance of the entity whose financial statements are being audited.

Introductory Paragraph. The introductory paragraph should (*a*) identify the entity whose financial statements have been audited, (*b*) state that the financial statements have been audited, (*c*) identify the title of each statement that comprises the financial statements, and (*d*) specify the date or period covered by each financial. The identification of the title of each statement that comprises the financial statements may be achieved by referencing the table of contents.

The auditor's report covers the complete set of financial statements, as defined by the applicable financial reporting framework. For example, in the case of many general purpose frameworks, the financial statements include a balance sheet, an income statement, a statement of changes in equity, and a cash flow statement, including related notes.

The identification of the title for each statement that the financial statements comprise may be achieved by listing them individually or by referencing the table of contents.

Management's Responsibility for the Financial Statements. This section should describe management's responsibility for the preparation and fair presentation of the financial statements. The description should include an explanation that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, which includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to error or fraud.

In some instances, a document containing the auditor's report may include a separate statement by management regarding its responsibility for the preparation of the financial statements. Generally accepted auditing standards (GAAS) do not permit including a reference to any separate statement by management about such responsibilities because this may lead users to erroneously believe that the auditor is providing assurances about representations made by management discussed elsewhere in the document.

Auditor's Responsibility. The section with this heading should describe that it is the auditor's responsibility to express an opinion on the financial statements based on the audit. This section should also include a statement that the audit was conducted in accordance with GAAS and that those standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The audit should be described by stating

- an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.
- the procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatements. In assessing those risks, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control, and, accordingly, no such opinion is expressed. (If the auditor has a responsibility to express an opinion on the effectiveness of the internal control in conjunction with the audit of the financial statements, the auditor should omit the phrase "the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control, and accordingly, no such opinion is expressed.")

- an audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as the overall presentation of the financial statements.

The auditor's report should include a statement about whether the auditor believes that the audit evidence he or she has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Auditor's Opinion. This section states the auditor's opinion that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in accordance with the applicable reporting framework and identifies the applicable reporting framework.

The auditor's opinion includes the identification of the financial statements as indicated in the introductory paragraph in order to describe the information that is the subject of the auditor's opinion.

Other Reporting Responsibilities. If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibility under GAAS to report on the financial statements, these reporting responsibilities should be addressed in a separate section subtitled, "Report on Other Legal and Regulatory Requirements," or otherwise, as appropriate.

If this section is included, all the sections discussed earlier should be under the subtitle, "Report on the Financial Statements," and this section should follow it.

Signature of the Auditor. The signature should include the manual or printed signature of the auditor's firm. In certain situations, the auditor's report may be required by law or regulation to include the personal name and signature of the auditor, in addition to the auditor's firm.

Auditor's Address. The auditor's report should include the name of the city and state where the auditor practices or the issuing office, if different. Note that this requirement may be met by placing the report on firm letterhead that includes the firm's address.

Date of the Auditor's Report. The auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that the audit documentation has been reviewed, all the financial statements and notes have been prepared, and management has taken responsibility for the financial statements.

Exhibit 9020-1, "Single Year Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America," is an example of an unmodified auditor's report.

.04 The preceding reporting requirements include a requirement to indicate that the audit was conducted in accordance with GAAS and identify the United States of America as the country of origin of those standards. However, an auditor may indicate that the audit was also conducted in accordance with another set of auditing standards (for example, International Standards on Auditing, the standards of the Public Company Accounting Oversight Board, or *Government Auditing Standards*). Paragraphs .41–.43 of AU-C section 700 address these situations. If the audit was conducted under GAAS and another set of auditing standards, the auditor's report should identify the other set of auditing standards, as well as their origin. The auditor should not refer to having conducted an audit in accordance with another set of auditing standards in addition to GAAS, unless the audit was conducted in accordance with both sets of standards in their entirety.

.05 Exhibit 9020-2, "Consolidated Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When the Audit Has Been Conducted in Accordance With Both Auditing Standards Generally Accepted in the United States of America and International Standards on Auditing," is an example of reporting under GAAS and another set of auditing standards.

.06 In some circumstances, the entity may be required by law, regulation, or standards, or may voluntarily choose, to include in the basic financial statements information that is not required by the applicable financial reporting framework. If the information cannot be clearly differentiated from the financial statements because of its nature and how it is presented, the auditor's opinion should cover this information as required by paragraph .58 of AU-C section 700.

.07 If the information included in the basic financial statements is not required by the applicable financial reporting framework and is not necessary for fair presentation but is clearly differentiated, then such information may be identified as *unaudited* or as *not covered by the auditor's report.*

.08 Auditors may be engaged to audit financial statements at an interim date, which is a date other than the fiscal year end of the entity. The auditor's report will contain the same elements as discussed previously. Exhibit 9020-3, "Interim Period Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America," includes an example of an auditor's report for an interim date.

.09 Reporting on interim financial statements is different than reporting on initial accounting periods. When reporting on interim financial statements, the period covered by the financial statements is not the first year of an entity's operations. When reporting on the initial period, the auditors are reporting on the first year of operations, which may be for a 12-month or shorter period.

.10 Exhibit 9020-4, "Initial Accounting Period Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America," includes an example of an auditor's reporting for an initial accounting period.

.11 At times, an entity may also engage an auditor to report on a period of time greater than 12 months. The periods may or may not end on the entity's fiscal year end, but the report wording would be the same in either case. The auditor's report should clearly indicate the period covered as required by paragraph .25*d* of AU-C section 700. A report covering more than 12 months may relate to the initial audit of a new entity. For example, an entity may begin operations on October 1, 20X1, and have its first audit cover the period from October 1, 20X1, through December 31, 20X2, a period of 15 months. The reporting in this situation would be the same as illustrated in exhibit 9020-4. Occasionally, an entity that is not new may request a report covering more than 12 months. The reporting in this situation would be the same as it is for interim period reporting, as shown in exhibit 9020-3, except that the number of months indicated would be more than 12, rather than fewer.

Illustrations of Auditor's Reports on Financial Statements

Exhibit 9020-1 — Single Year Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America

.12 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (single year).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements[1]

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[2] Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for

[1] The subtitle, "Report on the Financial Statements," is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

[2] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances." In addition, the next sentence, "Accordingly, we express no such opinion." would not be included.

the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9020-2 — Consolidated Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When the Audit Has Been Conducted in Accordance With Both Auditing Standards Generally Accepted in the United States of America and International Standards on Auditing

.13 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.
- The financial statements are audited in accordance with auditing standards generally accepted in the United States of America and International Standards on Auditing.

Independent Auditor's Report

[*Appropriate Addressee*]

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9020-3 — Interim Period Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America

.14 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (interim period).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as of June 30, 20X1,[1] and the related statements of income, changes in stockholders' equity, and cash flows for the six months then ended,[2] and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of June 30, 20X1,[3] and the results of its operations and its cash flows for the six

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[1] This interim report illustration differs from the report in exhibit 9020-1 in that the balance sheet date in the introductory and opinion paragraphs is the interim date.

[2] This interim report illustration differs from the report in exhibit 9020-1 in that the statements of income, changes in stockholders' equity, and cash flows are no longer "for the year then ended" but, instead, for the period that ends at the interim date, for example, "for the three months then ended."

[3] See footnote 1.

months then ended[4] in accordance with accounting principles generally accepted in the United States of America.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[4] See footnote 2.

Exhibit 9020-4 — Initial Accounting Period Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America

.15 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (initial period).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the period from inception (July 9, 20X1) to December 31, 20X1,[1] and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for

[1] This report illustration differs from the report in exhibit 9020-1 in that the statements of income, changes in stockholders' equity, and cash flows are no longer "for the year then ended" but, instead, include wording "for the period from inception."

the period from inception (July 9, 20X1) to December 31, 20X1[2] in accordance with accounting principles generally accepted in the United States of America.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[*The next page is 9201.*]

[2] See footnote 1.

AAM Section 9030

Modified Opinions

This section contains the following reference from AICPA *Professional Standards*:

AU-C Section:

- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

.01 The auditor may not have the ability to issue an unmodified auditor's report as a result of the financial statements being materially misstated, which includes departure from the applicable financial reporting framework (measurement or disclosure) or insufficient appropriate audit evidence. In addition, the auditor may request management to revise the financial statements when the auditor believes they need to be revised; however, management may refuse to do so. These circumstances may result in the issuance of a modified auditor's report or, potentially, the auditor's withdrawal from an engagement.

.02 AU-C section 705 addresses reporting when the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. This section establishes three types of modified opinions: qualified opinions, adverse opinions, and disclaimer of opinion. Before discussing the specifics of each type of the opinions mentioned, it is important to review the general circumstances that require a modification of the auditor's report.

.03 The decision regarding which type of modified opinion is appropriate depends upon the following:

a. The nature of the matter giving rise to the modification (that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated)

b. The auditor's professional judgment about the pervasiveness of the effects, or possible effects, of the matter on the financial statements

.04 *Pervasive* is a term used in the context of misstatements to describe the effects of misstatements on the financial statements or the possible effects of misstatements on the financial statements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's professional judgment

- are not confined to specific elements, accounts, or items of the financial statements;
- if so confined, represent, or could represent, a substantial proportion of the financial statements; or
- with regard to disclosures, are fundamental to the users' understanding of the financial statements.

.05 Based on the guidance in paragraph .29 of AU-C section 705, when the auditor expects to modify the opinion in the auditor's report, the auditor should communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification.

Qualified Opinion

.06 As described in paragraph .08 of AU-C section 705, the auditor should express a qualified opinion under two circumstances: first, when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements, and second, when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive. A qualified opinion uses "except for" to indicate that the auditors are satisfied with the financial statements as a whole, except for a particular item.

Adverse Opinion

.07 The auditor should express an adverse opinion, as explained in paragraph .09 of AU-C section 705, when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

.08 Adverse opinions are rare in practice because their implications are so serious that they usually cause the company to correct the financial statements. However, as with all modified opinions, when an adverse opinion is rendered, auditors describe in a separate paragraph of their report the reasons for the adverse opinion and, if reasonably determinable, their effects on the financial statements.

.09 In accordance with paragraph .15 of AU-C section 705, when the auditor considers it necessary to express an adverse opinion on the financial statements as a whole, the auditor's report also should not include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts, or items of a financial statement. To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion on the financial statements as a whole.

Disclaimer of Opinion

.10 Paragraph .10 of AU-C section 705 explains that the auditor should disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

.11 For example, in accordance with paragraph .16 of AU-C section 705, when the auditor is not independent but is required by law or regulation to report on the financial statements, the auditor should disclaim an opinion and should specifically state that the auditor is not independent. The auditor is neither required to provide, nor precluded from providing, the reasons for the lack of independence; however, if the auditor chooses to provide the reasons for the lack of independence, the auditor should include all the reasons therefore.

.12 Also, as stated in paragraph .15 of AU-C section 705, when the auditor considers it necessary to disclaim an opinion on the financial statements as a whole, the auditor's report also should not include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts, or items of a financial statement. To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's disclaimer of opinion on the financial statements as a whole.

.13 The following exhibit illustrates how specific circumstances and materiality affect the type of report that auditors issue.

.14

Exhibit 9030-1 — Types of Auditor Opinions

Type of Report	*Circumstance*	*Materiality*	*How to Modify the Auditor's Report*
Qualified opinion	Financial statements are materially misstated	Material but not pervasive	Add a separate explanatory paragraph preceding the opinion paragraph and qualify the opinion (except for). Include a heading that includes "Basis for Qualified Opinion."
	Inability to obtain sufficient appropriate audit evidence	Material but not pervasive	Modify the scope paragraph, add a separate explanatory paragraph preceding the opinion paragraph, and qualify the opinion (except for). Include a heading that includes "Basis for Qualified Opinion."
Adverse opinion	Financial statements are materially misstated	Material and pervasive	Add a separate explanatory paragraph preceding the opinion paragraph and modify the opinion to state "do not present fairly in accordance with" the applicable financial reporting framework. Include a heading that includes "Basis for Adverse Opinion."
Disclaimer of opinion	Inability to obtain sufficient appropriate audit evidence	Material and pervasive	Modify the introductory paragraph, delete the scope paragraph, add a separate explanatory paragraph, and modify the opinion paragraph to state "we do not express an opinion." Include a heading that includes "Basis for Disclaimer of Opinion."
	Not independent but is required by law or regulation to report on the financial statements	N/A	Disclaim an opinion and specifically state that the auditor is not independent. Include a heading that includes "Basis for Disclaimer of Opinion."

Basis for Modification Paragraph

.15 In accordance with paragraph .17 of AU-C section 705, when the auditor modifies the opinion on the financial statements, the auditor should, in addition to the specific elements required in section 9020, "Unmodified Opinions," include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification. The auditor should place this paragraph immediately before the opinion paragraph in the auditor's report and use a heading that includes "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate.

.16 As stated in paragraph .22 of AU-C section 705, even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor should

a. describe in the basis for modification paragraph any other matters of which the auditor is aware that would have required a modification to the opinion and the effects thereof and *b*. consider the need to describe in an emphasis-of-matter or other-matter paragraph(s) any other matters of which the auditor is aware that would have resulted in additional communications in the auditor's report on the financial statements that are not modifications of the auditor's opinion.

Opinion Paragraph

.17 Paragraph .23 of AU-C section 705 states when the auditor modifies the audit opinion, the auditor should use a heading that includes "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the opinion paragraph.

.18 If the auditor concludes the opinion on the financial statements should be qualified or adverse, the format of the auditor's report changes. A summary of the changes follows.

Description of the Auditor's Responsibility When the Auditor Expresses a Qualified or Adverse Opinion

.19 Paragraph .27 of AU-C section 705 explains that when the auditor expresses a qualified or adverse opinion, the auditor should amend the description of the auditor's responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

.20 The paragraph that is included will remain the same as that of an unmodified report, except the last sentence of the section that describes the auditor's responsibilities will indicate "qualified" or "adverse." The following illustrates the change that will be included:

- We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.
- We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Description of the Auditor's Responsibility When the Auditor Disclaims an Opinion

.21 Paragraph .28 of AU-C section 705 explains the changes to the standard paragraph describing the auditor's responsibility. When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor should amend the introductory paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements. The auditor should also amend the description of the auditor's responsibility and the description of the scope of the audit to state only: "Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter(s) described in the basis for disclaimer of opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion."

.22 A discussion of the modifications to the auditor's report as a result of material misstatements is discussed in section 9040, "Material Misstatements." The discussion related to the inability to obtain sufficient appropriate audit evidence is contained in section 9050, "Inability to Obtain Sufficient Appropriate Audit Evidence."

Withdrawal From an Audit Engagement

.23 There may be situations when the auditor concludes it is necessary to withdraw from an engagement instead of expressing a modified opinion. The practicality of withdrawing from the audit may depend on the stage of completion of the engagement at the time that management imposes the scope limitation. If the auditor has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion, and explain the scope limitation in the basis for disclaimer of opinion paragraph.

.24 In accordance with paragraph .14 of AU-C section 705, if the auditor concludes that withdrawal is necessary, the auditor should communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion. The auditor may also consider consulting legal counsel, if appropriate. Examples of situations when it may be necessary to withdraw from an engagement or client relationship include unauditable records, the denial of access to information the auditor considers necessary to perform the audit, detection of fraud or illegal acts, or other scope limitations.

.25 There may be circumstances when withdrawal from the audit may not be possible if the auditor is required by law or regulation to continue the audit engagement. This may be the case for an auditor who is appointed to audit the financial statements of governmental entities. It may also be the case in circumstances when the auditor is appointed to audit the financial statements covering a specific period, or appointed for a specific period, and is prohibited from withdrawing before the completion of the audit of those financial statements or before the end of that period, respectively. In these circumstances, the auditor may also consider it necessary to include an other-matter paragraph in the auditor's report.

[*The next page is 9251.*]

AAM Section 9040

Material Misstatements

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 450, *Evaluation of Misstatements Identified During the Audit*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

.01 The auditor may not have the ability to issue an unmodified auditor's report as a result of the financial statements being materially misstated. AU-C section 450 provides guidance and establishes requirements for the auditor's responsibility to evaluate the effect of uncorrected misstatements on the financial statements. In accordance with paragraphs .07–.09 of AU-C section 450, although the auditor should request that management correct misstatements accumulated during the audit, management may refuse to correct some or all of them. In that situation, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

.02 A *misstatement* is defined as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with the applicable financial reporting framework. Accordingly, a material misstatement of the financial statements may arise in relation to the following:

- The appropriateness of the selected accounting policies
- The application of the selected accounting policies
- The appropriateness of the financial statement presentation or the appropriateness or adequacy of disclosures in the financial statements

.03 With regard to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise when the selected accounting policies are not in accordance with the applicable financial reporting framework, or the financial statements, including the related notes, do not represent the underlying transactions and events in a manner that achieves fair presentation.

.04 With regard to the application of the selected accounting policies, material misstatements of the financial statements may arise in one of two ways. The first is when management has not applied the selected accounting policies in accordance with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application). The second is due to the method of application of the selected accounting policies (such as an unintentional error in application).

.05 With regard to the appropriateness of the financial statement presentation or the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when

- the financial statements do not include all the disclosures required by the applicable financial reporting framework;
- the disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework;

- the financial statements do not provide the disclosures necessary to achieve fair presentation; or
- information required to be presented in accordance with the applicable financial reporting framework is omitted either because a required statement (for example, a statement of cash flows) has not been included, or the information has not otherwise been disclosed in the financial statements.

Management Estimates

.06 Financial reporting frameworks often call for neutrality (that is, freedom from bias). However, accounting estimates are imprecise and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate.

.07 During the audit, the auditor may become aware of judgments and decisions made by management that give rise to indicators of possible management bias. Such indicators may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement. Examples of indicators of possible management bias include the following:

- Changes in an accounting estimate, or the method for making it, when management has made a subjective assessment that there has been a change in circumstances
- The use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable market assumptions
- The selection or construction of significant assumptions that yield a point estimate favorable for management objectives
- The selection of a point estimate that may indicate a pattern of optimism or pessimism

Basis for Modification Paragraph

.08 When the auditor modifies the opinion on the financial statements, the auditor should, in addition to the specific elements required in section 9030, "Modified Opinions," include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification. The auditor should place this paragraph immediately before the opinion paragraph in the auditor's report and use a heading that includes "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate. The guidance related to the "Basis for Modification" paragraph resides in paragraphs .17–.22 of AU-C section 705.

.09 If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures), the auditor should include in the basis for modification paragraph a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor should so state in the basis for modification paragraph.

.10 If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor should include in the basis for modification paragraph an explanation of how the disclosures are misstated.

.11 If there is a material misstatement of the financial statements that relates to the omission of information required to be presented or disclosed, the auditor should

- discuss the omission of such information with those charged with governance;
- describe in the basis for modification paragraph the nature of the omitted information; and

- include the omitted information, provided that it is practicable to do so, and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

.12 Even if the auditor has expressed an adverse opinion on the financial statements, the auditor should

- describe in the basis for modification paragraph any other matters of which the auditor is aware that would have required a modification to the opinion and the effects thereof and
- consider the need to describe in an emphasis-of-matter or other-matter paragraph(s) any other matters of which the auditor is aware that would have resulted in additional communications in the auditor's report on the financial statements that are not modifications of the auditor's opinion.

Opinion Paragraph

.13 Paragraphs .23–.25 of AU-C section 705 explain the changes to the opinion paragraph. When the auditor modifies the audit opinion, the auditor should use a heading that includes "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the opinion paragraph.

.14 When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor should state in the opinion paragraph that, in the auditor's opinion, except for the effects of the matter(s) described in the basis for qualified opinion paragraph, the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor should use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion. The inability to obtain sufficient appropriate audit evidence is discussed in section 9050, "Inability to Obtain Sufficient Appropriate Audit Evidence."

.15 When the auditor expresses an adverse opinion, the auditor should state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the basis for adverse opinion paragraph, the financial statements are not presented fairly in accordance with the applicable financial reporting framework.

[*The next page is 9301.*]

AAM Section 9050

Inability to Obtain Sufficient Appropriate Audit Evidence

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 210, *Terms of Engagement*
- AU-C section 402, *Audit Considerations Relating to an Entity Using a Service Organization*
- AU-C section 501, *Audit Evidence—Specific Considerations for Selected Items*
- AU-C section 580, *Written Representations*
- AU-C section 620, *Using the Work of an Auditor's Specialist*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

.01 The auditor may not have the ability to issue an unmodified auditor's report as a result of insufficient appropriate audit evidence.

.02 The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a *limitation on the scope of the audit*) may arise from circumstances beyond the control of the entity, circumstances relating to the nature or timing of the auditor's work, or limitations imposed by management.

.03 An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. Likewise, if the auditor has identified a specific procedure that should be performed in response to an assessed risk of material misstatement at the assertion level, it may not be possible to perform alternate procedures in order to obtain sufficient appropriate audit evidence. For example, the auditor may determine that a written response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. Such circumstances may include when information available to corroborate management's assertion(s) is only available outside the entity or when specific fraud risk factors, such as the risk of management override of controls or the risk of collusion, which can involve employee(s) or management, or both, prevent the auditor from relying on evidence from the entity.

.04 Another example of when sufficient appropriate audit evidence may not be obtained is when investments in securities are valued based on an investee's financial results, excluding investments accounted for using the equity method of accounting. The auditor should obtain sufficient appropriate audit evidence in support of the investee's financial results, as described by paragraph .04 of AU-C section 501, by performing appropriate procedures such as the following:

- Obtain and read available financial statements of the investee and the accompanying audit report, if any, including determining whether the report of the other auditor is satisfactory for this purpose.
- If the investee's financial statements are not audited, or if the audit report on such financial statements is not satisfactory to the auditor, apply or request that the investor entity arrange with the investee to have another auditor apply appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor entity.

- If the carrying amount of the investment reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, obtain sufficient appropriate audit evidence in support of such amounts.
- If the difference between the financial statement period of the entity and the investee has, or could have, a material effect on the entity's financial statements, determine whether the entity's management has properly considered the lack of comparability and determine the effect, if any, on the auditor's report.

If the auditor is not able to obtain sufficient appropriate audit evidence because of an inability to perform one or more of these procedures, the auditor determines the effect on the auditor's opinion.

.05 The auditor should request, through letter(s) of inquiry, the entity's legal counsel to inform the auditor of any litigation, claims, assessments, and unasserted claims that the counsel is aware of, together with an assessment of the outcome of the litigation, claims, and assessments, and an estimate of the financial implications, including costs involved. For more information on the requirements of the communication with the entity's legal counsel, see paragraphs .18–.24 of AU-C section 501.

.06 The auditor should modify the opinion in the auditor's report if

- the entity's legal counsel refuses to respond appropriately to the letter of inquiry, and the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, or
- management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel.

.07 The legal counsel may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome sometimes may not be within the legal counsel's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available, and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, the legal counsel may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor may conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event that cannot be reasonably estimated. If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor is required to modify the opinion in addressing the effect, if any, of the legal counsel's response on the auditor's report as a result of the scope limitation.

.08 If the auditor believes that there may be actual or potential material litigation, claims, or assessments, and the entity has not engaged external legal counsel relating to such matters, the auditor may discuss with the client the possible need to consult legal counsel to assist the client in determining the appropriate measurement, recognition, or disclosure of related liabilities or loss contingencies in the financial statements, in accordance with the applicable financial reporting framework. Depending on the significance of the matter(s), refusal by management to consult legal counsel in these circumstances may result in a scope limitation of the audit sufficient to preclude an unmodified opinion.

.09 The inability to observe inventory may also result in an inability to obtain sufficient appropriate audit evidence. In some cases, attendance is impracticable, and alternative audit procedures (for example, observing a current physical inventory count and reconciling it to the opening inventory quantities or inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting) may provide sufficient appropriate audit evidence about the existence and condition of inventory. If the audit covers the current period and one or more periods for which the auditor had not observed or made some physical counts of prior inventories, alternative audit procedures, such as tests of prior transactions or reviews of the records of prior counts, may provide sufficient appropriate audit evidence about the prior inventories. The effectiveness of the alternative procedures that an auditor may perform is affected by the length of the period that the alternative procedures cover.

.10 In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, the auditor is required to modify the opinion in the auditor's report as a result of the scope limitation.

.11 In some entities, controls over related party relationships and transactions within some entities may be deficient or nonexistent for a number of reasons, such as the following:

- The low importance attached by management to identifying and disclosing related party relationships and transactions
- The lack of appropriate oversight by those charged with governance
- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive (for example, the existence of transactions involving family members of management)
- An insufficient understanding by management of the applicable related party disclosure requirements

.12 When such controls are ineffective or nonexistent, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions. If this is the case, the auditor would consider modifying the audit report.

.13 The auditor is required to obtain an understanding of the control environment and internal controls of an entity and to assess the risk of material misstatement. Risks at the financial statement level may derive, in particular, from a deficient control environment, although these risks also may relate to factors such as declining economic conditions. For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

.14 The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example, concerns about the integrity of the entity's management may be so serious that the auditor concludes that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. In addition, concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

.15 The auditor is required to determine in these circumstances whether a need exists for the auditor to express a qualified or adverse opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement when withdrawal is possible under applicable law or regulation.

.16 Some audits involve the use of a service organization auditor's reports as a means to obtain sufficient appropriate audit evidence. If the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organization relevant to the audit of the user entity's financial statements, it would be appropriate to modify the opinion on the financial statements.

.17 The auditor may reference the work of a service organization auditor if it is relevant to an understanding of a modification of the user auditor's opinion; the user auditor's report should, however, indicate that such reference does not diminish the user auditor's responsibility for that opinion, as explained in paragraph .22 of AU-C section 402.

.18 Audits may also involve the use of an external specialist as part of obtaining sufficient appropriate audit evidence as discussed in AU-C section 620. If the use of an auditor's specialist is necessary to evaluate the work of a management specialist, the auditor should evaluate the adequacy of the work of the auditor's specialist for the auditor's purposes in accordance with paragraph .12 of AU-C section 620.

.19 If the auditor determines that the work of the auditor's specialist is not adequate for the auditor's purposes, the auditor should agree with the auditor's specialist on the nature and extent of further work to be performed by the auditor's specialist or perform additional audit procedures appropriate to the circumstances as discussed in paragraph .13 of AU-C section 620. If the auditor concludes that the work of the auditor's specialist is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures, it may be necessary to express a modified opinion in the auditor's report.

.20 If management, or those charged with governance of an entity, that is not required by law or regulation to have an audit impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement, such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements as a whole, the auditor should not accept such a limited engagement as an audit engagement as discussed in paragraph .07 of AU-C section 210.

.21 Scope limitations may be imposed by management or by circumstances. Examples of scope limitations that would not preclude the auditor from accepting the engagement include the following:

- A restriction imposed by management that the auditor believes will result in a qualified opinion
- A restriction imposed by circumstances beyond the control of management

.22 If management, or those charged with governance of an entity that is required by law or regulation to have an audit, imposes such a scope limitation and a disclaimer of opinion is acceptable under the applicable law or to the regulator, the auditor is permitted, but not required, to accept the engagement.

.23 If after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor should request that management remove the limitation as explained in paragraph .11 of AU-C section 705. Paragraph .12 of AU-C section 705 further addresses that if management refuses to remove the limitation, the auditor should communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

.24 If the auditor is unable to obtain sufficient appropriate audit evidence due to a management-imposed limitation and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive, the auditor should either disclaim an opinion on the financial statements or, when practicable, withdraw from the audit as explained in paragraph .13 of AU-C section 705.

.25 The practicality of withdrawing from the audit may depend on the stage of completion of the engagement at the time that management imposes the scope limitation. If the auditor has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion, and explain the scope limitation in the basis for disclaimer of opinion paragraph. Paragraph .14 of AU-C section 705 addresses when the auditor withdraws from an engagement. Before withdrawing, the auditor should communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

.26 For example, if management refuses to allow the auditor to perform external confirmation procedures, the auditor could

- inquire about management's reasons for the refusal and seek audit evidence about their validity and reasonableness;

- evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing, and extent of other audit procedures; and
- perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

.27 If the auditor concludes that management's refusal to allow the auditor to perform external confirmation procedures is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor should communicate with those charged with governance. The auditor would also determine the implications for the audit and the auditor's opinion.

.28 Paragraph .26 of AU-C section 580 contains guidance related to written representations from management. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit. If management does not provide one or more of the requested written representations, the auditor should discuss the matter with management, reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general, and take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

.29 Such refusal is often sufficient to preclude an unmodified opinion and may cause an auditor to disclaim an opinion or withdraw from the engagement when withdrawal is possible under applicable law or regulation. However, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate.

.30 The auditor's opinion is modified when the auditor expresses a qualified or adverse opinion or disclaims an opinion. The changes include modifications to the following sections of the auditor's report.

Auditor's Responsibility

.31 When the auditor expresses a qualified or an adverse opinion, the auditor amends the description of the auditor's responsibility to state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's qualified or adverse opinion.

.32 If the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor amends the introductory paragraph to state that the auditor was engaged to audit the financial statements. The auditor also amends the description of the auditor's responsibility and the description of the scope of the audit to state, "Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matter(s) described in the basis for disclaimer of opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion."

Basis for Modification Paragraph

.33 When the auditor modifies the opinion on the financial statements, the auditor should, in accordance with paragraph .17 of AU-C section 705, include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification, in addition to the specific elements required in section 9040, "Material Misstatements." The auditor should place this paragraph immediately before the opinion paragraph in the auditor's report and use a heading that includes "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate.

.34 If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor should include in the basis for modification paragraph the reasons for that inability as explained in paragraph .21 of AU-C section 705.

Opinion Paragraph

.35 When the auditor modifies the audit opinion, the auditor should use a heading that includes "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the opinion paragraph as described in paragraphs .23–.26 of AU-C section 705.

.36 When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor should state in the opinion paragraph that because of the significance of the matter(s) described in the basis for disclaimer of opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion and, accordingly, the auditor does not express an opinion on the financial statements.

[*The next page is 9351.*]

AAM Section 9060

Additional Communications in the Auditor's Report—Emphasis-of-Matter Paragraphs

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*
- AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*
- AU-C section 708, *Consistency of Financial Statements*

.01 The auditor, having formed an opinion on the financial statements, may be required to, or using professional judgment consider it necessary to, draw the users' attention to a matter appropriately presented or disclosed in the financial statements that is of such importance that it is fundamental to users' understanding of the financial statements. The auditor, in accordance with paragraphs .06–.07 of AU-C section 706, should include an emphasis-of-matter paragraph in the auditor's report, provided that the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph should refer only to information presented or disclosed in the financial statements. To include information in an emphasis-of-matter paragraph about a matter beyond what is presented or disclosed in the financial statements may raise questions about the appropriateness of such presentation or disclosure.

.02 When the auditor includes an emphasis-of-matter paragraph in the auditor's report, the auditor should

- include it immediately after the opinion paragraph in the auditor's report,
- use the heading "Emphasis of Matter" or other appropriate heading,
- include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements, and
- indicate that the auditor's opinion is not modified with respect to the matter emphasized.

.03 An emphasis-of-matter paragraph is required by generally accepted auditing standards in certain circumstances related to subsequently discovered facts, the auditor's consideration of the entity's ability to continue as a going concern, consistency of financial statements, and financial statements prepared in accordance with special purpose frameworks. The first three are discussed later in this section; requirements related to special purpose frameworks are discussed in section 9090, "Special Purpose Frameworks."

Subsequently Discovered Facts

.04 The auditor is not required to perform any audit procedures regarding the financial statements after the date of the auditor's report, as addressed in paragraphs .12–.14 of AU-C section 560. However, if a subsequently discovered fact becomes known to the auditor before or after the report release date, the auditor should discuss the matter with management and, when appropriate, those charged with governance, and determine whether the financial statements need revision and, if so, inquire how management intends to address the matter in the financial statements.

.05 If the matter was discovered prior to the report release date and management revises the financial statements, the auditor should perform the audit procedures necessary in the circumstances on the revision. The auditor then has two methods available for dating the auditor's report. The auditor may include an additional date limited to the revision (that is, dual-date the auditor's report for that revision) or date the auditor's report as of a later date. In the former instance, the auditor's responsibility for events occurring subsequent to the original date of the auditor's report is limited to the specific event described in the relevant note to the financial statements. In the latter instance, the auditor's responsibility for subsequent events extends to the new date of the auditor's report on the revised financial statements.

.06 When the auditor includes an additional date limited to the revision (a dual date), the original date of the auditor's report on the financial statements prior to their subsequent revision by management remains unchanged because this date informs the reader about when the auditor obtained sufficient appropriate audit evidence with respect to those financial statements prior to their subsequent revision. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to the original date of the auditor's report were limited to the subsequent revision of the financial statements. The following is an illustration of such wording:

> (Date of auditor's report), except as to note Y, which is as of (date of completion of audit procedures limited to revision described in note Y).

.07 If management does not revise the financial statements in circumstances when the auditor believes they need to be revised, the auditor should modify the opinion (express a qualified opinion or an adverse opinion), as addressed in AU-C section 705 and discussed in section 9030, "Modified Opinions."

.08 New information may also come to the auditor's attention after the report release date. Paragraphs .15–.18 of AU-C section 560 address the responsibilities of the auditor.

.09 If management revises the financial statements and the auditor's opinion on the financial statements is not impacted, the auditor should select one of the two reporting methods discussed earlier.

.10 If management revises the financial statements and the auditor's opinion on the revised financial statements differs from the opinion the auditor previously expressed, the auditor should disclose the following matters in an emphasis-of-matter or other-matter paragraph (discussed in section 9070, "Additional Communications in the Auditor's Report—Other-Matter Paragraphs"):

- The date of the auditor's previous report.
- The type of opinion previously expressed.
- The substantive reasons for the different opinion.
- The auditor's opinion on the revised financial statements is different from the auditor's previous opinion.

.11 If management does not revise the financial statements in circumstances when the auditor believes they need to be revised and if the audited financial statements have not been made available to third parties, the auditor should notify management and those charged with governance—unless all of those charged with governance are involved in managing the entity—not to make the audited financial statements available to third parties before the necessary revisions have been made and a new auditor's report on the revised financial statements has been provided.

.12 If the audited financial statements are, nevertheless, subsequently made available to third parties without the necessary revisions or if the audited financial statements had been made available to third parties, the auditor should assess whether the steps taken by management are timely and appropriate to ensure that anyone in receipt of the audited financial statements is informed of the situation, including that the audited financial statements are not to be relied upon.

.13 If management does not take the necessary steps to ensure that anyone in receipt of the audited financial statements is informed of the situation, the auditor should notify management and those charged with governance—unless all of those charged with governance are involved in managing the entity—that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take the necessary steps, the auditor should take appropriate action to seek to prevent reliance on the auditor's report. In this circumstance, the auditor may consider it appropriate to seek legal advice.

The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern

.14 AU-C section 570 addresses the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The auditor's evaluation is based on the auditor's knowledge of relevant conditions or events that exist at, or have occurred prior to, the date of the auditor's report. Information about such conditions or events is obtained from the application of audit procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited.

.15 If, after considering the identified conditions or events in the aggregate, the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a *reasonable period of time* (defined in paragraph .02 of AU-C section 570 as not to exceed one year beyond the date of the financial statements being audited), the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of such conditions or events, as discussed in paragraph .10 of AU-C section 570.

.16 If, after considering identified conditions or events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should include an emphasis-of-matter paragraph in the auditor's report to reflect that conclusion, as addressed in paragraph .15 of AU-C section 570.

.17 In accordance with paragraphs .16–.18 of AU-C section 570, the auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" or similar wording that includes the terms *substantial doubt* and *going concern*. The auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern. In addition, if the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, the auditor should modify the opinion in accordance with AU-C section 705, as discussed in section 9030.

.18 It should be noted that nothing in this section precludes an auditor from disclaiming an opinion in cases involving uncertainties. When the auditor disclaims an opinion, the report should not include the going concern emphasis-of-matter paragraph but, rather, describe the substantive reasons for the auditor's disclaimer of opinion. The auditor should consider the adequacy of disclosure of the uncertainties and their possible effects on the financial statements even when disclaiming an opinion.

Consistency of Financial Statements

.19 AU-C section 708 addresses the auditor's responsibility to evaluate the consistency of the financial statements for the periods presented and to communicate appropriately in the auditor's report when the comparability of financial statements between periods has been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements.

.20 In accordance with paragraph .06 of AU-C section 708, the periods included in the auditor's evaluation of consistency depend on the periods covered by the auditor's opinion on the financial statements. When the auditor's opinion covers only the current period, the auditor should evaluate whether the current-period financial statements are consistent with those of the preceding period, regardless of whether financial statements for the preceding period are presented. When the auditor's opinion covers two or more periods, the auditor should evaluate consistency between such periods and the consistency of the earliest period covered by the auditor's opinion with the period prior thereto, if such prior period is presented with the financial statements being reported upon. The auditor also should evaluate whether the financial statements for the periods being reported upon are consistent with previously issued financial statements for the relevant periods.

Change in Accounting Principle

.21 As defined in Financial Accounting Standards Board *Accounting Standards Codification* 250, *Accounting Changes and Error Corrections*, a *change in accounting principle* is a change from one generally accepted accounting principle to another generally accepted accounting principle when (1) two or more generally accepted accounting principles apply, or (2) the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.

.22 The guidance related to the auditor's responsibility related to a change in accounting principle is in paragraphs .07–.12 of AU-C section 708. The auditor should evaluate a change in accounting principle to determine whether

- the newly adopted accounting principle is in accordance with the applicable financial reporting framework,
- the method of accounting for the effect of the change is in accordance with the applicable financial reporting framework,
- the disclosures related to the accounting change are appropriate and adequate, and
- the entity has justified that the alternative accounting principle is preferable.

.23 If the auditor concludes that the previous criteria have been met, and the change in accounting principle has a material effect on the financial statements, the auditor should include an emphasis-of-matter paragraph in the auditor's report that describes the change in accounting principle and provides a reference to the entity's disclosure.

.24 If the previous criteria are not met, the auditor should evaluate whether the accounting change results in a material misstatement and whether the auditor should modify the opinion accordingly.

.25 The auditor should include an emphasis-of-matter paragraph relating to a change in accounting principle in reports on financial statements in the period of the change, and in subsequent periods, until the new accounting principle is applied in all periods presented. If the change in accounting principle is accounted for by retrospective application to the financial statements of all prior periods presented, the emphasis-of-matter paragraph is needed only in the period of such change.

.26 The auditor should evaluate and report on a change in accounting estimate that is inseparable from the effect of a related change in accounting principle like other changes in accounting principle. It is sometimes difficult to differentiate between a change in an accounting estimate and a change in an accounting principle because the change in accounting estimate may be inseparable from the effect of a related change in accounting principle. For example, when a change is made to the method of depreciation of an asset to reflect a change in the estimated future benefit of the asset or the pattern of consumption for those benefits, such a change in accounting may be inseparable from a change in estimate.

.27 When a change in the reporting entity results in financial statements that, in effect, are those of a different reporting entity, the auditor should include an emphasis-of-matter paragraph in the auditor's report. The paragraph should describe the change in the reporting entity and provide a reference to the entity's disclosure. However, if the change is the result of a transaction or event such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit, recognition in the auditor's report is not required. Examples of a change in the reporting entity that are not the result of a transaction or event include

- presenting consolidated or combined financial statements in place of financial statements of individual entities.
- changing specific subsidiaries that make up the group of entities for which consolidated financial statements are presented.
- changing the entities included in combined financial statements.

.28 If an entity's financial statements contain an investment accounted for using the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing entity's financial statements, the auditor should include an emphasis-of-matter paragraph in the auditor's report to describe the change in accounting principle.

.29 The date of the investor's financial statements, and those of the investee, may be different. If the difference between the date of the entity's financial statements and those of the investee has, or could have, a material effect on the entity's financial statements, the auditor is required to determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the difference between the financial statement period ends of the entity and investee are not consistent with the prior period in comparative statements or because a significant transaction occurred during the time period between the financial statement period end of the entity and investee. If a change in the difference between the financial statement period end of the entity and investee has a material effect on the investor's financial statements, the auditor may be required to add an emphasis-of-matter paragraph to the auditor's report because the comparability of financial statements between periods has been materially affected by a change in reporting period.

Correction of a Material Misstatement in Previously Issued Financial Statements

.30 As explained in paragraph .13 of AU-C section 708, the auditor should include an emphasis-of-matter paragraph in the auditor's report when there are adjustments to correct a material misstatement in previously issued financial statements. The auditor should include this type of emphasis-of-matter paragraph in the auditor's report when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent periods.

.31 A change from an accounting principle that is not in accordance with the applicable financial reporting framework to one that is in accordance with the applicable financial reporting framework is a correction of a misstatement. The emphasis-of-matter paragraph should include a statement that the previously issued financial statements have been restated for the correction of a material misstatement in the respective period and a reference to the entity's disclosure of the correction of the material misstatement in accordance with paragraph .14 of AU-C section 708.

.32 Changes in classification in previously issued financial statements do not require recognition in the auditor's report unless the change represents the correction of a material misstatement or a change in accounting principle. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were classified incorrectly in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement.

.33 In accordance with paragraph .15 of AU-C section 708, if the financial statement disclosures relating to the restatement to correct a material misstatement in previously issued financial statements are not adequate, the auditor should address the inadequacy of disclosure in accordance with AU-C section 705, as described in section 9030.

.34 In addition to the required emphasis-of-matter paragraphs already listed, the following are examples of circumstances when the auditor may consider it necessary to include an emphasis-of-matter paragraph:

- An uncertainty relating to the future outcome of unusually important litigation or regulatory action or accounting estimate
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position
- Significant transactions with related parties
- Unusually important subsequent events

.35 When, in the auditor's judgment, it is appropriate to include an emphasis-of-matter paragraph related to the previous items, the guidance discussed at the beginning of this section is applicable.

[*The next page is 9401.*]

AAM Section 9070

Additional Communications in the Auditor's Report — Other-Matter Paragraphs

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*
- AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*
- AU-C section 720, *Other Information in Documents Containing Audited Financial Statements*
- AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole*
- AU-C section 9725, *Supplementary Information in Relation to the Financial Statements as a Whole: Auditing Interpretations of Section 725*
- AU-C section 730, *Required Supplementary Information*
- AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*
- AU-C section 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements*
- AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication*

.01 The auditor, having formed an opinion on the financial statements, may consider it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report. The auditor should do this in a paragraph in the auditor's report with the heading "Other Matter" or other appropriate heading, as addressed in paragraph .08 of AU-C section 706. The auditor should include this paragraph immediately after the opinion paragraph and any emphasis-of-matter paragraph or elsewhere in the auditor's report if the content of the other-matter paragraph is relevant to the "Other Reporting Responsibilities" section.

.02 The content of an other-matter paragraph reflects clearly that such other matter is not required to be presented and disclosed in the financial statements. An other-matter paragraph does not include information that the auditor is prohibited from providing by law, regulation, or other professional standards (for example, ethical standards relating to the confidentiality of information). An other-matter paragraph also does not include information that is required to be provided by management.

.03 The placement of an other-matter paragraph depends on the nature of the information to be communicated. When an other-matter paragraph is included to draw users' attention to a matter relevant to their understanding of the audit of the financial statements, the paragraph is included immediately after the opinion paragraph and any emphasis-of-matter paragraph.

.04 In the rare circumstance when the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive, the auditor may consider it necessary to include an other-matter paragraph in the auditor's report to explain why it is not possible for the auditor to withdraw from the engagement.

.05 When an other-matter paragraph is included to draw users' attention to a matter relating to other reporting responsibilities addressed in the auditor's report, the paragraph may be included in the section subtitled, "Report on Other Legal and Regulatory Requirements."

.06 Law, regulation, or common practice may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or the auditor's report thereon. When relevant, one or more subheadings may be used that describe the content of the other-matter paragraph.

.07 An other-matter paragraph does not address circumstances when the auditor has other reporting responsibilities that are in addition to the auditor's responsibility under generally accepted auditing standards (GAAS) to report on the financial statements or when the auditor has been asked to perform and report on additional specified procedures or to express an opinion on specific matters.

.08 Alternatively, when relevant to all the auditor's responsibilities or users' understanding of the auditor's report, the other-matter paragraph may be included as a separate section following the "Report on the Financial Statements" and the "Report on Other Legal and Regulatory Requirements."

.09 An other-matter paragraph is required by GAAS in certain circumstances. These circumstances are outlined in exhibit C, "List of AU-C Sections Containing Requirements for Other-Matter Paragraphs," of AU-C section 706 and are further explained in the following sections.

Other Information in Documents Containing Audited Financial Statements

.10 The auditor is not required to make reference to the other information in the auditor's report on the financial statements. However, the auditor may include an other-matter paragraph disclaiming an opinion on the other information. For example, an auditor may choose to include a disclaimer on the other information when the auditor believes that he or she could be associated with the information, and the user may infer a level of assurance that is not intended.

.11 Other information may comprise the following:

- A report by management or those charged with governance on operations
- Financial summaries or highlights
- Employment data
- Planned capital expenditures
- Financial ratios
- Names of officers and directors
- Selected quarterly data

.12 In accordance with paragraphs .06 and .09 of AU-C section 720, the auditor should read the other information of which the auditor is aware in order to identify material inconsistencies, if any, with the audited financial statements. If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be revised.

.13 When the auditor identifies a material inconsistency prior to the date of the auditor's report that requires revision of the audited financial statements and management refuses to make the revision, the auditor should modify the auditor's opinion in accordance with AU-C section 705, as discussed in paragraph .10 of AU-C section 720 and section 9030, "Modified Opinions."

.14 As explained in paragraph .11 of AU-C section 720, when the auditor identifies a material inconsistency after the date of the auditor's report but prior to the report release date that requires revision of the audited financial statements, the auditor should apply the relevant requirements in AU-C section 560 and specifically include in the auditor's report an other-matter paragraph describing the material inconsistency (as discussed in relation to emphasis-of-matter paragraphs in section 9060, "Additional Communications in the Auditor's Report—Emphasis-of-Matter Paragraphs").

.15 When the auditor identifies a material inconsistency prior to the report release date that requires revision of the other information and management refuses to make the revision, the auditor should communicate this matter to those charged with governance and withhold the auditor's report, or when withdrawal is possible under applicable law or regulation, withdraw from the engagement in accordance with paragraph .12 of AU-C section 720.

Supplementary Information in Relation to the Financial Statements as a Whole

.16 Supplementary information includes additional details or explanations of items in, or related to, the basic financial statements, consolidating information, historical summaries of items extracted from the basic financial statements, statistical data, and other material, some of which may be from sources outside the accounting system or outside the entity.

.17 In order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor, in accordance with paragraph .05 of AU-C section 725 should determine that all the following conditions are met:

- The supplementary information was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.
- The supplementary information relates to the same period as the financial statements.
- The financial statements were audited, and the auditor issued a report on those financial statements.
- Neither an adverse opinion nor a disclaimer of opinion was issued on the financial statements.
- The supplementary information will accompany the entity's audited financial statements, or such audited financial statements will be made readily available by the entity.

.18 As explained in paragraph .09 of AU-C section 725, when the entity presents the supplementary information with the financial statements, the auditor should report on the supplementary information in either an other-matter paragraph or in a separate report on the supplementary information. The other-matter paragraph or separate report should include the following elements:

- A statement that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole
- A statement that the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements
- A statement that the supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements

- A statement that the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves and other additional procedures, in accordance with generally accepted auditing standards
- If the auditor issues an unmodified opinion on the financial statements and the auditor has concluded that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, a statement that, in the auditor's opinion, the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole
- If the auditor issues a qualified opinion on the financial statements and the qualification has an effect on the supplementary information, a statement that, in the auditor's opinion, except for the effects on the supplementary information of (refer to the paragraph in the auditor's report explaining the qualification) such information is fairly stated, in all material respects, in relation to the financial statements as a whole

.19 When the audited financial statements are not presented with the supplementary information, the auditor should, in accordance with paragraph .10 of AU-C section 725, report on the supplementary information in a separate report. When reporting separately on the supplementary information, the report should include, in addition to the preceding elements, a reference to the report on the financial statements, the date of that report, the nature of the opinion expressed on the financial statements, and any report modifications.

.20 As explained in paragraph .11 of AU-C section 725, when the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion and the auditor has been engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to such financial statements as a whole, the auditor is precluded from expressing an opinion on the supplementary information. When permitted by law or regulation, the auditor may withdraw from the engagement to report on the supplementary information. If the auditor does not withdraw, the auditor's report on the supplementary information should state that because of the significance of the matter disclosed in the auditor's report, it is inappropriate to, and the auditor does not, express an opinion on the supplementary information.

.21 The date of the auditor's report on the supplementary information in relation to the financial statements as a whole should not be earlier than the date on which the auditor completed the procedures required in relationship to the supplementary information as described in paragraph .12 of AU-C section 725.

.22 If the auditor concludes, on the basis of the procedures performed, that the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revision of the supplementary information. If management does not revise the supplementary information, the auditor should either modify the auditor's opinion on the supplementary information and describe the misstatement in the auditor's report or, if a separate report is being issued on the supplementary information, withhold the auditor's report on the supplementary information in accordance with paragraph .13 of AU-C section 725.

.23 In practice, financial statements may contain comparative financial statements and supplementary information. Reporting on comparative financial statements is discussed further in section 9100, "Comparative Financial Statements."

Required Supplementary Information

.24 Required supplementary information is information that a designated accounting standards setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standards setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.

.25 The auditor, as addressed in paragraph .07 of AU-C section 730, should include an other-matter paragraph in the auditor's report on the financial statements to refer to the required supplementary information. The other-matter paragraph should include language to explain the following circumstances, as applicable:

- The required supplementary information is included, and the auditor has applied the procedures required in AU-C section 730.
- The required supplementary information is omitted.
- Some required supplementary information is missing, and some is presented in accordance with the prescribed guidelines.
- The auditor has identified material departures from the prescribed guidelines.
- The auditor is unable to complete the procedures in AU-C section 730.
- The auditor has unresolved doubts about whether the required supplementary information is presented in accordance with prescribed guidelines.

.26 Because the required supplementary information accompanies the basic financial statements, the auditor's report on the financial statements includes a discussion of the responsibility taken by the auditor on that information. However, because the required supplementary information is not part of the basic financial statements, the auditor's opinion on the fairness of presentation of such financial statements in accordance with the applicable financial reporting framework is not affected by the presentation by the entity of the required supplementary information or the failure to present some or all of such required supplementary information. Furthermore, if the required supplementary information is omitted by the entity, the auditor does not have a responsibility to present that information.

.27 If the entity has presented all or some of the required supplementary information, the other-matter paragraph should, in accordance with paragraph .08 of AU-C section 730, include the following elements:

- A statement that [*identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] require that the [*identify the required supplementary information*] be presented to supplement the basic financial statements
- A statement that such information, although not a part of the basic financial statements, is required by [*identify designated accounting standards setter*], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
- If the auditor is able to complete the procedures in AU-C section 730
    - — a statement that the auditor has applied certain limited procedures to the required supplementary information in accordance with auditing standards, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to the auditor's inquiries, the basic financial statements, and other knowledge the auditor obtained during the audit of the basic financial statements
    - — a statement that the auditor does not express an opinion or provide any assurance on the information because the limited procedures do not provide the auditor with sufficient evidence to express an opinion or provide any assurance
- If the auditor is unable to complete the procedures in AU-C section 730,
    - — a statement that the auditor was unable to apply certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States because [*state the reasons*]

   - a statement that the auditor does not express an opinion or provide any assurance on the information

- If some of the required supplementary information is omitted
   - a statement that management has omitted [*description of the missing required supplementary information*] that [*identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] require to be presented to supplement the basic financial statements
   - a statement that the missing information, although not a part of the basic financial statements, is required by [*identify designated accounting standards setter*], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
   - a statement that the auditor's opinion on the basic financial statements is not affected by the missing information
- If the measurement or presentation of the required supplementary information departs materially from the prescribed guidelines, a statement that although the auditor's opinion on the basic financial statements is not affected, material departures from prescribed guidelines exist [*describe the material departures from the applicable financial reporting framework*]
- If the auditor has unresolved doubts about whether the required supplementary information is measured or presented in accordance with prescribed guidelines, a statement that although the auditor's opinion on the basic financial statements is not affected, the results of the limited procedures have raised doubts about whether material modifications should be made to the required supplementary information for it to be presented in accordance with guidelines established by [*identify designated accounting standards setter*]

.28 In accordance with paragraph .09 of AU-C section 730, if all the required supplementary information is omitted, the other-matter paragraph should include the following elements:

- A statement that management has omitted [*description of the missing required supplementary information*] that [*identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] require to be presented to supplement the basic financial statements
- A statement that such missing information, although not a part of the basic financial statements, is required by [*identify designated accounting standards setter*], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
- A statement that the auditor's opinion on the basic financial statements is not affected by the missing information

.29 An entity may prepare one set of financial statements in accordance with a general purpose framework (for example, accounting principles generally accepted in the United States of America) and another set of financial statements in accordance with another general purpose framework (for example, International Financial Reporting Standards promulgated by the International Accounting Standards Board) and engage the auditor to report on both sets of financial statements. If the auditor has determined that the frameworks are acceptable in the respective circumstances, the auditor may include an other-matter paragraph in the auditor's report referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.

.30 Other areas where the requirements of an other-matter paragraph are discussed can be found in later sections and include AU-C sections 800, 806, and 905.

Procedures Performed on Supplementary Information After the Date of the Auditor's Report

.31 The dating of the auditor's report on supplementary information should not be earlier than the date on which the auditor completed the procedures related to the information. However, as addressed in AU-C section 9725, when the auditor completes those procedures subsequent to the date of the auditor's report on the audited financial statements, the auditor is not required to obtain additional evidence with respect to the audited financial statements. When reporting on the supplementary information (either in a separate report or in an explanatory paragraph within the auditor's report on the financial statements) after the date of the auditor's report on the financial statements, an auditor may make it clear that no additional procedures were performed on the audited financial statements subsequent to the date of the auditor's report on those financial statements.

.32 The auditor may do this by issuing a separate report on the supplementary information and including in such report a statement that the auditor has not performed any auditing procedures with respect to the audited financial statements subsequent to the date of the auditor's report on those audited financial statements. Alternately, the auditor may reissue a report on the audited financial statements to include an explanatory paragraph to report on the supplementary information and include two report dates to indicate that the date of reporting on the supplementary information is as of a later date.

[*The next page is 9451.*]

AAM Section 9080

Special Considerations in the United States

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole*
- AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*
- AU-C section 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements*
- AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication*
- AU-C section 910, *Financial Statements Prepared in Accordance with a Financial Reporting Framework Generally Accepted in Another Country*
- AU-C section 915, *Reports on Application of Requirements of an Applicable Financial Reporting Framework*

.01 Certain reporting situations are encountered within the United States that may not be encountered under the auditing standards of other standard-setting bodies. This chapter includes a discussion of the items that may require special consideration of the auditor prior to reporting on the financial statements of an entity.

.02 AU-C section 905 addresses when the auditor is required to, or chooses to, restrict the use of a written communication. Auditor's written communications may include the auditor's report, letters, or presentation materials (for example, letters communicating internal control related matters or presentations addressing communications with those charged with governance). This section will only address restricted use as it relates to the auditor's report.

.03 An auditor is not responsible for controlling, and cannot control, distribution of the auditor's written communication after its release. The alert that restricts the use of the auditor's written communication is designed to avoid misunderstandings related to the use of the auditor's written communication, particularly if the auditor's written communication is taken out of the context in which the auditor's written communication is intended to be used. An auditor may consider informing the entity or other specified parties that the auditor's written communication is not intended for distribution to parties other than those specified in the auditor's written communication. The auditor may, in connection with establishing the terms of the engagement, reach an understanding with the entity that the intended use of the auditor's written communication will be restricted and may obtain the entity's agreement that the entity and specified parties will not distribute such auditor's written communication to parties other than those identified therein.

.04 In accordance with paragraphs .06–.07 of AU-C section 905, when the subject matter of the auditor's written communication is based on the following, the auditor's written communication should include an alert, in a separate paragraph, that restricts its use:

- Measurement or disclosure criteria that are determined by the auditor to be suitable only for a limited number of users who can be presumed to have an adequate understanding of the criteria
- Measurement or disclosure criteria that are available only to the specified parties
- Matters identified by the auditor during the course of the audit engagement when the identification of such matters is not the primary objective of the audit engagement (commonly referred to as a *by-product report*)

.05 When it is determined that it is necessary to include an alert that restricts the use of the auditor's written communication, it should contain the following elements, unless specified otherwise within various other sections of AICPA *Professional Standards*:

- A statement that the auditor's written communication is intended solely for the information and use of the specified parties.
- Identification of the specified parties for whom use is intended. In situations covered by the preceding paragraph, the specified parties should only include management, those charged with governance, others within the entity, the parties to the contract or agreement, or the regulatory agencies to whose jurisdiction the entity is subject, as appropriate in the circumstances.
- A statement that the auditor's written communication is not intended to be, and should not be, used by anyone other than the specified parties.

.06 The following illustrates language that includes the elements that are required:

> This [*report, letter, presentation, or communication*] is intended solely for the information and use of [*list or refer to the specified parties*] and is not intended to be, and should not be, used by anyone other than these specified parties.

Adding Other Specified Parties

.07 At times, when the auditor has included an alert that restricts the use of the auditor's written communication to certain specified parties, the auditor is requested to add other parties as specified parties. The auditor should determine whether to agree to add the other parties as specified parties; this determination may be based on the auditor's consideration of factors such as the identity of the other parties and the intended use of the auditor's written communication. The guidance for adding other specified parties resides in paragraphs .08–.10 of AU-C section 905.

.08 When the auditor agrees to add other parties as specified parties before the release of the auditor's written communication, the auditor should obtain affirmative acknowledgment, in writing, from the other parties of their understanding of

- the nature of the engagement resulting in the auditor's written communication,
- the measurement or disclosure criteria related to the subject matter of the auditor's written communication, and
- the auditor's written communication.

.09 If the other parties are added after the release of the auditor's written communication, in addition to the preceding requirements, the auditor should take one of the following actions:

- Amend the auditor's written communication to add the other parties. In such circumstances, the auditor should not change the original date of the auditor's written communication.
- Provide a written acknowledgment to management and the other parties that such parties have been added as specified parties. The auditor should state in the acknowledgment that no procedures were performed subsequent to the original date of the auditor's written communication or the date that the engagement was completed, as appropriate.

.10 In situations relating to written communications of matters identified by the auditor during the course of the audit engagement when the identification of such matters is not the primary objective of the audit engagement (commonly referred to as a *by-product report*), the auditor should not agree to the request to include parties other than management, those charged with governance, others within the entity, the parties to the contract or agreement, or the regulatory agencies to whose jurisdiction the entity is subject in accordance with paragraph .06 of AU-C section 905.

.11 Within various sections of AICPA *Professional Standards*, there are specific requirements to include an alert that restricts the use of the auditor's written communication or that otherwise address the inclusion of such alerts.

.12 Paragraph .A16 of AU-C section 725 discusses including an alert that restricts the use of a separate report on supplementary information. Such an alert may be included at the option of the auditor with the objective of avoiding potential misinterpretation or misunderstanding of the supplementary information that is not presented with the financial statements.

Reports on Application of Requirements of an Applicable Financial Reporting Framework

.13 AU-C section 915 addresses the reporting responsibilities when the accountant is requested to issue a written report on the application of the requirements of an applicable financial reporting framework to a specific transaction or the type of report that may be issued on a specific entity's financial statements.

.14 In practice, differing interpretations may exist concerning whether existing accounting policies in an applicable financial reporting framework apply to new transactions or how new accounting policies in an applicable financial reporting framework apply to existing transactions. Management and others may consult with accountants on the application of the requirements of an applicable financial reporting framework to those transactions or to increase their knowledge of specific financial reporting issues. Such consultations may provide relevant information and insights not otherwise available.

.15 As explained in paragraph .14 of AU-C section 915, the reporting accountant's written report should be addressed to the requesting party (for example, management or those charged with governance) and should include the following:

- A brief description of the nature of the engagement and a statement that the engagement was performed in accordance with this section.
- Identification of the specific entity; a description of the specific transaction(s), if applicable; a statement of the relevant facts, circumstances, and assumptions; and a statement about the source of such information.
- A statement describing the appropriate application of the requirements of an applicable financial reporting framework (including the country of origin) to the specific transaction or type of report that may be issued on the entity's financial statements and, if appropriate, a description of the reasons for the reporting accountant's conclusion.
- A statement that the responsibility for the proper accounting treatment rests with the preparers of the financial statements, who should consult with their continuing accountant.
- A statement that any difference in the facts, circumstances, or assumptions presented may change the report.
- An alert that restricts the use of the report solely to the specified parties.
- If the reporting accountant is not independent of the entity, a statement indicating the reporting accountant's lack of independence. The reporting accountant is neither required to provide, nor precluded from providing, the reasons for the lack of independence; however, if the reporting accountant chooses to provide the reasons for the lack of independence, the reporting accountant should include all the reasons therefor.

.16 Other AICPA *Professional Standards* sections that also contain a discussion related to an alert that restricts the use of a report include AU-C sections 800 and 806. Both will be discussed in section 9090, "Special Purpose Frameworks," and section 9130, "Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements," respectively.

.17 An auditor practicing within the United States may be engaged to report on financial statements that have been prepared in accordance with a financial reporting framework generally accepted in another country and not adopted by a body designated by the Council of the AICPA to establish accounting principles generally accepted in the United States of America (GAAP) (hereinafter referred to as a *financial reporting framework generally accepted in another country*) when such audited financial statements are intended for use outside the United States. Under this scenario, AU-C section 910 applies.

.18 The form of the report will differ depending upon whether its use will only be outside the United States versus use within the United States.

Reporting — Use Only Outside the United States

.19 Even when the form and content of the auditor's report used in another country appears similar to that used in the United States, the report may convey a different meaning and entail different legal responsibilities for the auditor due to custom or culture. Issuing a report of another country may require the auditor to report on statutory compliance or otherwise require understanding of local laws and regulations. When issuing the auditor's report of another country, the auditor is required to obtain an understanding of applicable legal responsibilities, in addition to the auditing standards and the financial reporting framework generally accepted in the other country. Accordingly, depending on the nature and extent of the auditor's knowledge and experience, the auditor may consult with persons having expertise in the audit reporting practices of the other country and associated legal responsibilities to obtain the understanding needed to issue that country's report.

.20 In accordance with paragraph .12 of AU-C section 910, if the auditor is reporting on financial statements prepared in accordance with a financial reporting framework generally accepted in another country that are intended for use only outside the United States, the auditor should report using either

- a U.S. form of report that reflects that the financial statements being reported on have been prepared in accordance with a financial reporting framework generally accepted in another country, including
  - — the elements discussed in section 9020, "Unmodified Opinions," and
  - — a statement that refers to the note to the financial statements that describes the basis of presentation of the financial statements on which the auditor is reporting, including identification of the country of origin of the accounting principles, or
- the report form and content of the other country (or, if applicable, as set forth in the International Standards on Auditing), provided that
  - — such a report would be issued by auditors in the other country in similar circumstances,
  - — the auditor understands and has obtained sufficient appropriate audit evidence to support the statements contained in such a report, and
  - — the auditor has complied with the reporting standards of that country and identifies the other country in the report.

.21 An entity that prepares financial statements in accordance with GAAP may also prepare financial statements in accordance with a financial reporting framework generally accepted in another country for use outside the United States, for example, financial statements prepared in accordance with a jurisdictional variation of International Financial Reporting Standards (IFRSs) such that the entity's financial statements do not contain an explicit and unreserved statement of compliance with IFRSs as issued by the International Accounting Standards Board. In such circumstances, the auditor may report on the financial statements that are in accordance with a financial reporting framework generally accepted in another country by reporting in accordance with the preceding requirements. The auditor may include in one or both of the reports a statement that another report has been issued on the financial statements for the entity that have been prepared in accordance with a financial reporting framework generally accepted in another country. The auditor's statement may also reference any note disclosure in the financial statements that describes significant differences between the accounting principles used and GAAP. An example of such a statement, which may be included in an emphasis-of-matter paragraph, is as follows:

> We also have reported separately on the financial statements of ABC Company for the same period presented in accordance with [*specify the financial reporting framework generally accepted*] in [*name of country*]. (The significant differences between the [*specify the financial reporting framework generally accepted*] in [*name of country*] and accounting principles generally accepted in the United States of America are summarized in Note X.)

Reporting — Use in the United States

.22 As discussed in paragraph .13 of AU-C section 910, if financial statements prepared in accordance with a financial reporting framework generally accepted in another country also are intended for use in the United States, the auditor should report using the U.S. form of report, as discussed in earlier sections. In addition, the auditor should include in the auditor's report an emphasis-of-matter paragraph that

- identifies the financial reporting framework used in the preparation of the financial statements,
- refers to the note to the financial statements that describes that framework, and
- indicates that such framework differs from GAAP.

.23 When reporting on financial statements prepared in accordance with a financial reporting framework generally accepted in another country that will be used in the United States and outside the United States, the auditor may issue two reports: one as described previously for use outside the United States and the other, which is a U.S. form of report with an emphasis-of-matter paragraph for use in the United States.

[*The next page is 9501.*]

AAM Section 9090

Special Purpose Frameworks

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 210, *Terms of Engagement*
- AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*

.01 The information contained in the preceding sections applies to audits of all financial statements. This section addresses special considerations in the application of that guidance to an audit of financial statements prepared in accordance with a special purpose framework, which is a cash, tax, regulatory, or contractual basis of accounting. AU-C section 800 addresses these types of reports.

.02 A *special purpose framework* is a financial reporting framework other than accounting principles generally accepted in the United States of America (GAAP) that is one of the following bases of accounting:

- **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets).
- **Tax basis.** A basis of accounting that the entity uses to file its income tax return for the period covered by the financial statements.
- **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject (for example, a basis of accounting that insurance companies use pursuant to the accounting practices prescribed or permitted by a state insurance commission).
- **Contractual basis.** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.
- **Other basis.** A basis of accounting that utilizes a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

The cash, tax, and regulatory bases of accounting are commonly referred to as *other comprehensive bases of accounting*.

.03 In accordance with paragraph .06 of AU-C section 210, prior to accepting an engagement to report on financial statements prepared in accordance with a special purpose framework, the auditor should determine the acceptability of the financial reporting framework. In an audit of special purpose financial statements, the auditor, as discussed in paragraph .10 of AU-C section 800, should obtain an understanding of the purpose for which the financial statements are prepared, the intended users, and the steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.

.04 When forming an opinion and reporting on special purpose financial statements, the auditor should apply the requirements that were discussed in section 9020, "Unmodified Opinions." If the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary, the auditor should apply the requirements discussed in section 9030, "Modified Opinions." Appendix A, "Overview of Reporting Requirements," of AU-C section 800 provides an overview of the reporting requirements applicable to the special purpose framework previously identified in this section.

.05 The auditor is required to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. In an audit of special purpose financial statements, the auditor should evaluate whether the financial statements are suitably titled and include a summary of significant accounting policies in accordance with paragraph .15 of AU-C section 800. Terms such as *balance sheet*, *statement of financial position*, *statement of income*, *statement of operations*, and *statement of cash flows*, or similar unmodified titles, are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in accordance with GAAP. The following table contains sample financial statement titles.

Sample Statement Titles

GAAP Titles	*Special Purpose Framework Titles*
Balance Sheet	Statement of Assets, Liabilities, and Stockholders' Equity (Partners' Capital, Proprietor's Capital)—Income Tax Basis (Cash Basis, Modified Cash Basis, Regulatory Basis, Contractual Basis)
Statement of Income	Statement of Revenue and Expenses—Income Tax Basis (Cash Basis, Modified Cash Basis, Regulatory Basis, Contractual Basis)
Statement of Changes in Stockholders' Equity	Statement of Changes in Stockholders' Equity (Partners' Capital, Proprietor's Capital)—Income Tax Basis (Cash Basis, Modified Cash Basis, Regulatory Basis, Contractual Basis)
Statement of Income and Retained Earnings	Statement of Revenue, Expenses, and Retained Earnings (Partners' Capital, Proprietor's Capital)—Income Tax Basis (Cash Basis, Modified Cash Basis, Regulatory Basis, Contractual Basis)
Statement of Cash Flows	Statement of Cash Activity—Income Tax Basis (Cash Basis, Modified Cash Basis, Regulatory Basis, Contractual Basis) (The statement of cash flows may not be a required statement for financial statements prepared in accordance with a special purpose framework.)

.06 In accordance with paragraphs .15–.17 of AU-C section 800, the auditor should evaluate if the financial statements adequately describe how the special purpose framework differs from GAAP. The description of how the special purpose framework differs from GAAP ordinarily would only include the material differences between GAAP and the special purpose framework. For example, if several items are accounted for differently under the special purpose framework than they would be under GAAP, but only the differences in how depreciation is calculated are material, a brief description of the depreciation differences is all that would be necessary, and the remaining differences would not be described. The differences would not be quantified.

.07 In the case of special purpose financial statements prepared in accordance with a contractual basis of accounting, the auditor should also evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

Fair Presentation

.08 The auditor is required to evaluate whether the financial statements achieve fair presentation. In an audit of special purpose financial statements, when the special purpose financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP, the auditor should evaluate whether the financial statements include informative disclosures similar to those required by GAAP. For example, financial statements prepared on a tax basis or on a modified cash basis of accounting usually reflect depreciation, long-term debt, and owners' equity. Thus, the informative disclosures for depreciation, long-term debt, and owners' equity in such financial statements would be comparable to those in financial statements prepared in accordance with GAAP.

.09 The auditor should also evaluate whether additional disclosures beyond those specifically required by the framework, related to matters that are not specifically identified on the face of the financial statements or other disclosures, are necessary for the financial statements to achieve fair presentation. For example, these disclosures may include matters about related party transactions, restrictions on assets and owners' equity, subsequent events, and significant uncertainties. In such circumstances, the special purpose financial statements would include the same disclosure required by GAAP or disclosure that communicates the substance of those requirements.

Management's Responsibility

.10 Within the auditor's report, there should be an explanation of management's responsibility for the financial statements, including reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances, when management has a choice of financial reporting frameworks in the preparation of such financial statements as described in paragraph .18 of AU-C section 800.

Purpose of the Financial Statements

.11 The auditor's report, in accordance with paragraph .18 of AU-C section 800, should also describe the purpose for which the financial statements are prepared or refer to a note in the special purpose financial statements that contains that information, when the financial statements are prepared in accordance with a regulatory or contractual basis of accounting. This description is necessary to avoid misunderstandings when the special purpose financial statements are used for purposes other than those for which they were intended. The note to the financial statements may also describe any significant interpretations of the contract on which the financial statements are based.

.12 The auditor's report on special purpose financial statements generally should include an emphasis-of-matter paragraph under an appropriate heading that indicates that the financial statements are prepared in accordance with the applicable special purpose framework, refers to the note to the financial statements that describes that framework, and states that the special purpose framework is a basis of accounting other than GAAP as required by paragraph .19 of AU-C section 800. The emphasis-of-matter paragraph is necessary to avoid misunderstandings if the financial statements are used for purposes other than those for which they were intended.

Restriction on Use

.13 The auditor's report on special purpose financial statements should include an other-matter paragraph, as described in paragraph .20 of AU-C section 800, under an appropriate heading, that restricts the use of the auditor's report solely to those within the entity, the parties to the contract or agreement, or the regulatory agencies to whose jurisdiction the entity is subject when the special purpose financial statements are prepared in accordance with either a contractual basis of accounting or a regulatory basis of accounting.

.14 Special purpose financial statements prepared in accordance with a contractual or regulatory basis of accounting are suitable only for a limited number of users who can be presumed to have an adequate understanding of such bases of accounting. For example, special purpose financial statements prepared in accordance with a contractual basis of accounting are developed for and directed only to the parties to the contract or agreement. Accordingly, the alert that restricts the use of the auditor's report is required due to the nature of the report and the potential for the report to be taken out of the context in which the auditor's report was intended to be used.

.15 The exception to including the emphasis-of-matter or other-matter paragraph is when the special purpose financial statements are prepared in accordance with a regulatory basis of accounting, and the special purpose financial statements, together with the auditor's report, are intended for general use. Such special purpose financial statements are intended for general use when the financial statements, together with the auditor's report, are intended for use by parties other than those within the entity and the regulatory agencies to whose jurisdiction the entity is subject or when the financial statements, together with the auditor's report, are distributed by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject, either voluntarily or upon specific request. In accordance with paragraph .21 of AU-C section 800, in this circumstance, the auditor should express an opinion about whether the special purpose financial statements are presented fairly, in all material respects, in accordance with GAAP. The auditor should also, in a separate paragraph, express an opinion about whether the financial statements are prepared in accordance with the special purpose framework.

.16 Exhibit 9090-1, "Overview of Reporting Requirements," contains illustrations of the reporting requirements for financial statements prepared in accordance with a special purpose framework.

Requirement on Format

.17 In accordance with paragraphs .22–.23 of AU-C section 800, if the auditor is required by law or regulation to use a specific layout, form, or wording of the auditor's report, the auditor's report should refer to generally accepted auditing standards (GAAS) only if the auditor's report includes, at a minimum, each of the following elements:

- A title
- An addressee
- An introductory paragraph that identifies the special purpose financial statements audited
- A description of the responsibility of management for the preparation and fair presentation of the special purpose financial statements
- A reference to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances when required
- A description of the purpose for which the financial statements are prepared when required
- A description of the auditor's responsibility to express an opinion on the special purpose financial statements and the scope of the audit, which includes
    - — a reference to GAAS and, if applicable, the law or regulation
    - — a description of an audit in accordance with those standards
    - — an opinion paragraph containing an expression of opinion on the special purpose financial statements and a reference to the special purpose framework used to prepare the financial statements (including identifying the origin of the framework) and, if applicable, an opinion on whether the special purpose financial statements are presented fairly, in all material respects, in accordance with GAAP when required
- An emphasis-of-matter paragraph that indicates that the financial statements are prepared in accordance with a special purpose framework when required
- An other-matter paragraph that restricts the use of the auditor's report when required
- The auditor's signature
- The auditor's city and state
- The date of the auditor's report

.18 If the prescribed specific layout, form, or wording of the auditor's report is not acceptable or would cause an auditor to make a statement that the auditor has no basis to make, the auditor should reword the prescribed form of the report or attach an appropriately worded separate report.

.19 If the auditor determines that rewording the prescribed form or attaching a separate report would not be permitted or would not mitigate the risk of users misunderstanding the auditor's report, the auditor should not accept the audit engagement unless the auditor is required by law or regulation to do so. An audit performed in accordance with such law or regulation does not comply with GAAS. Accordingly, for such an audit, the auditor should not include any reference to the audit having been performed in accordance with GAAS within the auditor's report.

Exhibit 9090-1 — Overview of Reporting Requirements

.20 The following table provides an overview of the reporting requirements depending on the special purpose framework.

	Cash Basis	*Tax Basis*	*Regulatory Basis*	*Regulatory Basis (General Use)*	*Contractual Basis*
Opinion(s)	Single opinion on special purpose framework	Single opinion on special purpose framework	Single opinion on special purpose framework	Dual opinion on special purpose framework and generally accepted accounting principles	Single opinion on special purpose framework
Description of purpose for which special purpose financial statements are prepared	No	No	Yes	Yes	Yes
Emphasis-of-matter paragraph alerting readers regarding the preparation in accordance with a special purpose framework	Yes	Yes	Yes	No	Yes
Other-matter paragraph, including an alert restricting the use of the auditor's report	No	No	Yes	No	Yes

[*The next page is 9551.*]

AAM Section 9100

Comparative Financial Statements

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*
- AU-C section 580, *Written Representation*
- AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*

.01 Comparative financial statements may be required by the applicable financial reporting framework, or management may elect to provide such information. In practice, the issuance of comparative financial statements is more prevalent than the issuance of single-period financial statements. Guidance relative to comparative financial statements is included in paragraphs .44–.57 of AU-C section 700. When comparative financial statements are presented, the auditor's report should refer to each period for which financial statements are presented and on which an audit opinion is expressed. Because the auditor's report on comparative financial statements applies to the financial statements for each period presented, the auditor may express different opinions on one or more financial statements of another period presented.

.02 The auditor's report on comparative financial statements should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to support the opinion for the most recent audit.

.03 A continuing auditor should update the report on the financial statements of one or more prior periods presented on a comparative basis with those of the current period. The information considered by the continuing auditor is that which the auditor has become aware of during the audit of the current period financial statements.

.04 If comparative information is presented but not covered by the auditor's opinion, the auditor should clearly indicate in the auditor's report the character of the auditor's work, if any, and the degree of responsibility the auditor is taking. Comparative information may include condensed financial statements or prior period summarized financial information. This is not considered comparative financial statements because it is not a complete set of financial statements. In these circumstances, the auditor need not opine on comparative information in accordance with this section.

.05 Procedures exist that should be performed by an auditor if comparative financial statements or comparative information is presented for the prior periods. First, the auditor should determine whether the comparative information is presented in accordance with the requirements, if any, of the applicable reporting framework.

.06 Second, the auditor should evaluate whether the comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, has been restated for the correction of a material misstatement or adjusted for the retrospective application of an accounting principle and determine that the accounting policies are consistent with those applied in the current period or if there have been changes, whether those changes have been properly accounted for and adequately presented and disclosed.

.07 If the auditor becomes aware of possible material misstatement in the comparative information while performing the current period audit, the auditor should perform additional procedures to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists and follow the relevant requirements of AU-C section 560. If the prior period financial statements are restated, the auditor should determine that the comparative financial statements or comparative information agree with the restated financial statements.

.08 Third, as required by AU-C section 580, the auditor should request written representations from management for all periods referred to in the auditor's opinion. The auditor should also obtain a specific written representation regarding any restatement made to correct a material misstatement in a prior period that affects the comparative financial statements.

.09 Exhibits 9100-1–9100-7 are examples of auditor's reports on comparative financial statements and summarized comparative information.

.10 If the auditor's opinion on the prior periods included in comparative financial statements differs from the opinion previously expressed, the auditor should disclose in an emphasis-of-matter or other-matter paragraph

- the date of the auditor's previous report,
- the type of opinion previously expressed,
- the substantive reasons for the different opinion, and
- that the auditor's opinion on the amended financial statements is different from the auditor's previous opinion.

.11 The auditor should also determine if there are additional reporting responsibilities to prevent future reliance on the auditor's previously issued report of the prior period financial statements.

.12 Exhibit 9100-8, "Unmodified Opinion on Current Year; Updated Opinion on Prior Year Reflecting Correction of a GAAP Departure," is an example of an auditor's report on comparative financial statements with an opinion that is different than previously expressed. If the financial statements of the prior period were audited by a predecessor auditor, and the predecessor auditor's report on the prior period's financial statements is not reissued, in addition to expressing an opinion on the current period's financial statements, the auditor should refer to the predecessor's report in an other-matter paragraph that states

- that the prior period financial statements were audited by a predecessor auditor,
- the type of opinion expressed and, if the opinion was modified, the reasons therefore,
- the nature of any emphasis-of-matter or other-matter paragraphs included in the predecessor's report, and
- the date of the predecessor's report.

.13 Exhibits 9100-9–9100-13 are examples of an auditor's report on comparative financial statements, which include references to the predecessor's audit report.

.14 If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor should request management to inform the predecessor auditor of the situation and arrange for the three parties to discuss this information and attempt to resolve the matter. The auditor should communicate to the predecessor auditor information that the auditor believes the predecessor auditor may need to consider, in accordance AU-C section 560, which addresses the auditor's responsibilities when facts become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

.15 If the prior period financial statements are restated, and the predecessor auditor agrees to issue a new auditor's report on the restated financial statements of the prior period, then the auditor should express an opinion only on the current period.

.16 The predecessor auditor may be unable or unwilling to reissue the auditor's report on the prior period financial statements that have been restated. In this situation, provided that the auditor has audited the adjustments to the prior period financial statements, the auditor may include an other-matter paragraph in the auditor's report indicating that the predecessor auditor reported on the financial statements of the prior period before restatement. In addition, if the auditor is engaged to audit and obtains sufficient appropriate audit evidence to be satisfied about the appropriateness of the restatement, the auditor's report may also include the following paragraph within the other-matter paragraph section.

> **Other Matter**
>
> As part of our audit of the 20X2 financial statements, we also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the Company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements as a whole.

.17 If management refuses to inform the predecessor auditor that the prior period financial statements may need revision or if the auditor is not satisfied with the resolution of the matter, the auditor should evaluate the implications on the current engagement and whether to withdraw from the engagement or, when withdrawal is not possible under applicable law or regulation, disclaim an opinion on the financial statements.

.18 When the current period financial statements are audited and presented in comparative form with compiled or reviewed financial statements of the prior period, and the report on the prior period is not reissued, the auditor should include an other-matter paragraph in the current period auditor's report that states

- the service performed in the prior period,
- the date of the report on the prior period,
- a description of any modifications noted in that report, and
- a statement that the service was less in scope than an audit and does not provide the basis for an opinion on the financial statements.

.19 If the prior period financial statements were reviewed, the following is an example of an other-matter paragraph:

> **Other Matter**
>
> The 20X1 financial statements were reviewed by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) were not aware of any material modifications that should be made to those statements for them to be in conformity with accounting principles generally accepted in the United States of America. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements.

.20 If the prior period financial statements were compiled, the following is an example of an other-matter paragraph:

> **Other Matter**
>
> The 20X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

.21 If the prior period financial statements are not audited, reviewed, or compiled, the financial statements should be clearly marked to indicate their status, and the auditor's report should include an other-matter paragraph stating that the auditor has not audited, reviewed, or compiled the prior period financial statements and assumes no responsibility for them. The following is an example of such an other-matter paragraph.

Other Matter

The accompanying balance sheet of X Company as of December 31, 20X1, and the related statements of income and cash flows for the year then ended were not audited, reviewed, or compiled by us and, accordingly, we do not express an opinion or any other form of assurance on them.

Illustrations of Auditor's Reports on Financial Statements

Exhibit 9100-1 — Consolidated Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America

.22 Circumstances include the following:

- Audit of a complete set of general purpose consolidated financial statements (comparative).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements[1]

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[2] Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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[1] The subtitle, "Report on the Financial Statements," is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

[2] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances." In addition, the next sentence, "Accordingly, we express no such opinion." would not be included.

Opinion

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

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-2 — Single Year Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When Comparative Summarized Financial Information Derived From Audited Financial Statements for the Prior Year Is Presented

.23 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (single year).
- Prior year summarized comparative financial information derived from audited financial statements is presented.
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited the accompanying financial statements of XYZ Not-for-Profit Organization, which comprise the statement of financial position as of September 30, 20X1, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the organization's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the organization's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of September 30, 20X1, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Summarized Comparative Information

We have previously audited the XYZ Not-for-Profit Organization's 20X0 financial statements, and we expressed an unmodified audit opinion on those audited financial statements in our report dated December 15, 20X0. In our opinion, the summarized comparative information presented herein as of and for the year ended September 30, 20X0 is consistent, in all material respects, with the audited financial statements from which it has been derived.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-3 — Single Year Prepared in Accordance With U.S. GAAP When Comparative Summarized Financial Information Derived From Audited Financial Statements Audited by a Predecessor Auditor for the Prior Year Is Presented

.24 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (single year).
- Prior year summarized comparative financial information derived from audited financial statements is presented.
- Prior year financial statements were audited by a predecessor auditor.
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited the accompanying financial statements of XYZ Not-for-Profit Organization, which comprise the statement of financial position as of September 30, 20X1, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the organization's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the organization's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of September 30, 20X1, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Summarized Comparative Information

The prior year summarized comparative information has been derived from the XYZ Not-for-Profit Organization's 20X0 financial statements which were audited by other auditors. In their report dated December 15, 20X0, they expressed an unqualified opinion on those financial statements.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-4 — Single Year Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When Comparative Summarized Financial Information Derived From Unaudited Financial Statements for the Prior Year Is Presented

.25 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (single year).
- Prior year summarized comparative financial information derived from unaudited financial statements is presented.
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited the accompanying financial statements of XYZ Not-for-Profit Organization, which comprise the statement of financial position as of September 30, 20X1, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the organization's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the organization's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of September 30, 20X1, and the changes in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Summarized Comparative Information

The summarized comparative information presented herein as of and for the year ended September 30, 20X0, derived from those unaudited financial statements, has not been audited, reviewed, or compiled and, accordingly, we express no opinion on it.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-5 — Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When There has Been a Change in the Year End of the Entity

.26 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative year).
- Current year financial information is for less than six months.
- Prior year financial information is for the previous year.
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X1 and June 30, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the six-month and twelve-month periods[1] then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the organization's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the organization's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 and June 30, 20X1, and the results of their operations and

[1] The report indicates the periods of time for each period being reported on.

their cash flows for the six months and twelve months[2] then ended in accordance with accounting principles generally accepted in the United States of America.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[2] See footnote 1.

Exhibit 9100-6 — Unmodified Opinion in the Prior Year and Modified Opinion (Qualified Opinion) in the Current Year

.27 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative) prepared in accordance with accounting principles generally accepted in the United States of America.
- Certain lease obligations have been excluded from the financial statements in the current year. The effect of the exclusion is material but not pervasive. The auditor expressed an unmodified opinion in the prior year and is expressing a modified opinion (qualified opinion) in the current year.

Independent Auditor's Report

[*Appropriate Addressee*]

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

The Company has excluded, from property and debt in the accompanying 20X1 balance sheet, certain lease obligations that were entered into in 20X1 which, in our opinion, should be capitalized in accordance with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $XXX, long-term debt by $XXX, and retained earnings by $XXX as of December 31, 20X1, and net income and earnings per share would be increased (decreased) by $XXX and $XXX, respectively, for the year then ended.

Qualified Opinion

In our opinion, except for the effects on the 20X1 financial statements of not capitalizing certain lease obligations as described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-7 — Unmodified Opinion in the Current Year and Disclaimer of Opinion on the Prior-Year Statements of Income, Changes in Stockholders' Equity, and Cash Flows

.28 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative) prepared in accordance with accounting principles generally accepted in the United States of America.
- The auditor was unable to observe the physical inventory as at December 31, 20X0, because at that time the auditor had not been engaged. Accordingly, the auditor was unable to obtain sufficient appropriate audit evidence regarding the net income and cash flows for the year ended December 31, 20X1. The effects of the inability to obtain sufficient appropriate audit evidence are deemed material and pervasive.
- The auditor expressed an unmodified opinion on December 31, 20X1 and 20X0 balance sheets and a disclaimer of opinion on the 20X0 statements of income, changes in stockholders' equity, and cash flows.

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. Except as explained in the Basis for Disclaimer of Opinion paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions on the balance sheets as of December 31, 20X2 and 20X1, and the statements of income, changes in stockholders' equity, and cash flows for the year ended December 31, 20X2.

Basis for Disclaimer of Opinion on 20X1 Operations and Cash Flows

We did not observe the taking of the physical inventory as of December 31, 20X0, because that date was prior to our engagement as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0 enter into the determination of net income and cash flows for the year ended December 31, 20X1.

Disclaimer of Opinion on 20X1 Operations and Cash Flows

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the results of operations and cash flows for the year ended December 31, 20X1. Accordingly, we do not express an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

Opinion

In our opinion, the balance sheets of ABC Company as of December 31, 20X2 and 20X1, and the statements of income, changes in stockholders' equity, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in accordance with accounting principles generally accepted in the United States of America.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-8 — Unmodified Opinion on Current Year; Updated Opinion on Prior Year Reflecting Correction of a GAAP Departure

.29 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP).
- Opinion on prior year comparative financial statements was previously qualified due to a GAAP departure.
- GAAP departure was corrected in the current year, and the opinion has been updated.

Independent Auditor's Report

[*Appropriate Addressee*]

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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

Emphasis of Matter

In our report dated February 20, 20X1, we expressed an opinion that the 20X0 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America because the Company had not recognized deferred income. As described in Note 1, the Company has changed its method of accounting for deferred income taxes and had restated its 20X0 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our presentation on the 20X0 financial statements, as presented herein, is different from that expressed in our previous report.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-9 — Unmodified Opinion on Current Year; Reference to Predecessor Auditor's Unmodified Opinion

.30 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.
- Opinion on current year financial statements is unmodified.
- Predecessor auditor's opinion was unmodified.

Independent Auditor's Report

[*Appropriate Addressee*]

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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

Other Matter

The financial statements of ABC Company as of December 31, 20X0, were audited by other auditors whose report dated March 15, 20X1, expressed an unmodified opinion on those statements.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-10 — Unmodified Opinion on Current Year; Reference to Predecessor Auditor's Unmodified Opinion With an Emphasis of Matter Paragraph for Going Concern

.31 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.
- Opinion on current year financial statements is unmodified.
- Predecessor auditor's opinion was qualified because of a going concern uncertainty that continues in the current period.

Independent Auditor's Report

[*Appropriate Addressee*]

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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

Emphasis of Matter Regarding Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

Other Matter

The financial statements of ABC Company as of December 31, 20X0, were audited by other auditors whose report dated March 15, 20X1, expressed an unmodified opinion on those statements and included an emphasis of matter regarding the Company's ability to continue as a going concern as discussed in Note X those financial statements.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-11 — Qualified Opinion on Current Year; Reference to Predecessor Auditor's Qualified Opinion

.32 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP).
- Opinion on current year financial statements is qualified due to GAAP departure.
- Predecessor auditor's opinion was qualified due to a GAAP departure that continues in the current period.

Independent Auditor's Report

[*Appropriate Addressee*]

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

The Company has stated inventories at cost in the accompanying balance sheets. Accounting principles generally accepted in the United States of America require inventories to be stated at the lower of cost or market. If the Company stated inventories at the lower of cost or market, a write down of $XXX would have been required as of December 31, 20X1. Accordingly, cost of sales would have been increased by $XXX, and net income, income taxes, and stockholders' equity would have been reduced by $XXX, $XXX, and $XXX, respectively, as of and for the year ended December 31, 20X1.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of TLM Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter

The financial statements of ABC Company as of December 31, 20X0, were audited by other auditors whose report dated March 15, 20X1, expressed a qualified opinion on those statements because of the departure from generally accepted accounting principles described in the basis for qualified opinion paragraph above.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-12 — Comparative Consolidated Financial Statements and Supplementary Information When Predecessor Auditors Have Audited the Prior Period Financial Statements and Supplementary Information

.33 Circumstances include the following:

- Audit of a complete set of general purpose financial statements (comparative).
- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America.
- Opinion on current year financial statements is unmodified, in relation to opinion expressed on supplementary information.
- Predecessor auditor's opinion was unmodified, in relation to opinion expressed on supplementary information.

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited the accompanying consolidated balance sheet of TLM Company and subsidiaries as of December 31, 20X1, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

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

Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The 20X1 [*identify accompanying supplementary information*] on pages XX-XX is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the 20X1 consolidated financial statements as a whole.

Other Matter

The consolidated financial statements of TLM Company as of December 31, 20X0, were audited by other auditors whose report dated March 15, 20X1, expressed an unmodified opinion on those statements. The 20X0 [*identify accompanying supplementary information*] on pages XX-XX was subjected to the auditing procedures applied in the 20X0 audit of the basic financial statements by other auditors, whose report on such information stated that it was fairly stated in all material respects in relation to the 20X0 consolidated financial statements as a whole.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

Exhibit 9100-13 — A Separate Report When the Auditor Is Issuing an Unmodified Opinion on the Financial Statements and an Unmodified Opinion on the Supplementary Information; Reference to Predecessor Auditor

.34

Independent Auditor's Report on Supplementary Information

We have audited the financial statements of TLM Company as of and for the year ended June 30, 20X1, and have issued our report thereon dated [*date of the auditor's report on the financial statements*], which contained an unmodified opinion on those financial statements. Our audit was performed for the purpose of forming an opinion on the financial statements as a whole. The 20X1 [*identify supplementary information*] on pages XX-XX is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the 20X1 financial statements as a whole.

The financial statements of TLM Company as of and for the year ended June 30, 20X0, were audited by other auditors whose report dated [*date of the predecessor auditor's report on the financial statements*] expressed an unmodified opinion on those statements. The 20X0 [*identify accompanying supplementary information*] on pages XX-XX was subjected to the auditing procedures applied in the 20X0 audit of the basic financial statements by other auditors, whose report on such information stated that it was fairly stated in all material respects in relation to the 20X0 financial statements as a whole.

[*The next page is 9601.*]

AAM Section 9110

Initial Audit Engagements

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*
- AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*
- AU-C section 705, *Modifications to the Opinion in the Independent Auditor's Report*

.01 This section addresses the auditor's responsibilities relating to opening balances in an initial audit engagement, including a reaudit engagement, as addressed in AU-C section 510. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

.02 This section, with respect to predecessor auditors, does not apply if the most recent audited financial statements are more than one year prior to the beginning of the earliest period to be audited.

.03 In conducting an initial audit engagement, including a reaudit engagement, the objective of the auditor is to obtain sufficient appropriate audit evidence regarding opening balances about whether opening balances contain misstatements that materially affect the current period's financial statements and that appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

.04 Within generally accepted auditing standards, the following terms have the meanings attributed as follows:

Initial audit engagement. An engagement in which either the financial statements for the prior period were not audited, or the financial statements for the prior period were audited by a predecessor auditor.

Opening balances. Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

Predecessor auditor. The auditor from a different audit firm who has reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements.

Reaudit. An initial audit engagement to audit financial statements that have been previously audited by a predecessor auditor.

.05 In accordance with paragraphs .06–.07 of AU-C section 510, the auditor should read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures, and consistency in the application of accounting policies.

.06 In instances in which the prior period financial statements were audited by a predecessor auditor, the auditor should request management to authorize the predecessor auditor to allow a review of the predecessor auditor's audit documentation and for the predecessor auditor to respond fully to the auditor's inquiries, thereby providing the auditor with information to assist in planning and performing the engagement.

Opening Balances

.07 As explained in paragraph .08 of AU-C section 510, the auditor should obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by

- determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;
- determining whether the opening balances reflect the application of appropriate accounting policies; and
- evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances and performing one or both of the following:
  - When the prior year financial statements were audited, reviewing the predecessor auditor's audit documentation to obtain evidence regarding the opening balances
  - Performing specific audit procedures to obtain evidence regarding the opening balances

.08 The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as the following:

- The accounting policies followed by the entity
- The nature of the account balances, classes of transactions and disclosures, and the risks of material misstatement in the current period's financial statements
- The significance of the opening balances relative to the current period's financial statements
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified

.09 For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness, and valuation at the beginning of the period. In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures, such as one or more of the following, may be necessary to obtain sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities
- Performing audit procedures on the valuation of the opening inventory items
- Performing audit procedures on gross profit and cutoff

.10 For noncurrent assets and liabilities, such as property, plant, and equipment, investments, and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties (for example, for long-term debt and investments). In other cases, the auditor may need to carry out additional audit procedures.

.11 In accordance with paragraphs .15–.16 of AU-C section 510, if the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor should express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with AU-C section 705, which was discussed in section 9050, "Inability to Obtain Sufficient Appropriate Audit Evidence."

.12 If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or adequately presented or disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate, in accordance with AU-C section 705, as discussed in section 9040, "Material Misstatements."

.13 If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor should, as explained in paragraph .09 of AU-C section 510, perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor should communicate the misstatements to the appropriate level of management and those charged with governance. If the prior period financial statements were audited by a predecessor auditor, the auditor should also refer to the paragraphs later in this section regarding discovery of possible material misstatements in financial statements reported on by a predecessor auditor.

Consistency of Accounting Policies

.14 As described in paragraph .10 of AU-C section 510, the auditor should obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements and whether changes in the accounting policies have been appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

.15 If the auditor concludes that the current period's accounting policies are not consistently applied regarding opening balances in accordance with the applicable financial reporting framework, or a change in accounting policies is not appropriately accounted for or adequately presented or disclosed in accordance with the applicable financial reporting framework, the auditor should express a qualified opinion or an adverse opinion.

Relevant Information in the Predecessor Auditor's Report

.16 In accordance with paragraphs .11 and .18 of AU-C section 510, if the prior period's financial statements were audited by a predecessor auditor, and a modification was made to the opinion, the auditor should evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements.

.17 If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor should modify the auditor's opinion on the current period's financial statements.

Discovery of Possible Material Misstatements in Financial Statements Reported on by a Predecessor Auditor

.18 If the auditor becomes aware of information during the audit that leads the auditor to believe that financial statements reported on by the predecessor auditor may require revision, the auditor should, in accordance with paragraphs .12–.13 of AU-C section 510, request management to inform the predecessor auditor of the situation and arrange for the three parties to discuss this information and attempt to resolve the matter. The auditor should communicate to the predecessor auditor information that the auditor believes the predecessor auditor may want to consider, in accordance with AU-C section 560, which addresses the auditor's responsibilities when facts become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

.19 If management refuses to inform the predecessor auditor that the prior period financial statements may need revision or if the auditor is not satisfied with the resolution of the matter, the auditor should evaluate the implications on the current engagement and whether to withdraw from the engagement or, when withdrawal is not possible under applicable law or regulation, disclaim an opinion on the financial statements. The auditor may also seek legal advice in determining the appropriate course of action.

Audit Conclusions and Reporting

.20 The auditor should not make reference to the report or work of the predecessor auditor as the basis, in part, for the auditor's own opinion as described in paragraph .14 of AU-C section 510.

.21 Exhibit 9110-1, "Auditor's Disclaimer of Opinion on Results of Operations and Cash Flows and Unmodified Opinion on Financial Position," is an example of the reporting requirements discussed within this section.

Illustrations of Auditor's Reports on Financial Statements

Exhibit 9110-1 — Auditor's Disclaimer of Opinion on Results of Operations and Cash Flows and Unmodified Opinion on Financial Position

.22 Circumstances include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material and pervasive to the entity's results of operations and cash flows.[1]
- The financial position at year-end is fairly presented.
- A disclaimer of opinion regarding the results of operations and cash flows and an unmodified opinion regarding financial position is considered appropriate in the circumstances.

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements[2]

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X1, and were engaged to audit the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with auditing standards generally accepted in the United States of America. Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the income statement and the cash flow statement.

We conducted our audit of the balance sheet in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances

[1] If the possible effects, in the auditor's professional judgment, are considered to be material but not pervasive to the entity's results of operations and cash flows, the auditor would express a qualified opinion on the results of operations and cash flows.

[2] The subtitle, "Report on the Financial Statements," is unnecessary in circumstances when the second subtitle, "Report on Other Legal and Regulatory Requirements," is not applicable.

but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[3] Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unmodified opinion on the balance sheet.

Basis for Disclaimer of Opinion on the Results of Operations and Cash Flows

We were not engaged as auditors of the Company until after December 31, 20X0, and, therefore, did not observe the counting of physical inventories at the beginning of the year. We were unable to satisfy ourselves by performing other auditing procedures concerning the inventory held at December 31, 20X0. Because opening inventories enter into the determination of net income and cash flows, we were unable to determine whether any adjustments might have been necessary in respect of the profit for the year reported in the income statement and the net cash flows from operating activities reported in the cash flow statement.

Disclaimer of Opinion on the Results of Operations and Cash Flows

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the results of operations and cash flows for the year ended December 31, 20X1. Accordingly, we do not express an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

Opinion on the Balance Sheet

In our opinion, the balance sheet presents fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, in accordance with accounting principles generally accepted in the United States of America.

Report on Other Legal and Regulatory Requirements

[*Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.*]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[*The next page is 9651.*]

[3] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances." In addition, the next sentence, "Accordingly, we express no such opinion." would not be included.

AAM Section 9120

Single Financial Statement and Specific Elements, Accounts, or Items

This section contains the following reference from AICPA *Professional Standards*:

AU-C Section:

- AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*

.01 This section addresses special considerations in the application of the prior sections to an audit of a single financial statement or of a specific element, account, or item of a financial statement as addressed in AU-C section 805. The single financial statement or the specific element, account, or item of a financial statement may be prepared in accordance with a general or special purpose framework.

.02 For purposes of this section, reference to

- an *element of a financial statement* or *an element* means an element, account, or item of a financial statement.
- a *single financial statement* or a *specific element of a financial statement* includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or the specific element.

.03 As previously discussed, the auditor is required to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements. In the case of an audit of a single financial statement or a specific element of a financial statement, the auditor should, in accordance with paragraph .10 of AU-C section 805, obtain an understanding of

- the purpose for which the single financial statement or specific element of a financial statement is prepared,
- the intended users, and
- the steps taken by management to determine that the application of the financial reporting framework is acceptable in the circumstances.

.04 This determination should include consideration of whether the application of the financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the specific element and the effect of material transactions and events on the information conveyed in the financial statement or the specific element as described in paragraph .11 of AU-C section 805.

.05 The individual financial statements that comprise a complete set of financial statements and many of the elements of those financial statements, including their related notes, are interrelated. For example, sales and receivables, inventory and payables, and buildings and equipment and depreciation each are interrelated. Accordingly, when auditing a single financial statement or a specific element of a financial statement, the auditor may not be able to consider the single financial statement or the specific element in isolation. Consequently, as explained in paragraph .13 of AU-C section 805, the auditor should perform procedures on interrelated items as necessary to meet the objective of the audit. In the case of an audit of a specific element that is, or is based upon, the entity's stockholders' equity or net income (or the equivalents thereto), the auditor is required to perform procedures necessary to obtain sufficient appropriate audit evidence about financial position or financial position and results of operations, respectively, because of the interrelationship between the specific element and the balance sheet accounts and the income statement accounts. However, matters related to classification or disclosure may not be relevant to the audit of the specific element; therefore, audit procedures on such matters may not be necessary in an audit of a specific element.

.06 The auditor, in forming an opinion, is required to evaluate whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements. In the case of an audit of a single financial statement or a specific element of a financial statement, it is important, in view of the requirements of the applicable financial reporting framework, that the disclosures enable the intended users to understand the information conveyed in the financial statement or the specific element and the effect of material transactions and events on the information conveyed in the financial statement or the specific element.

.07 In conjunction with an engagement to audit the entity's complete set of financial statements, if the auditor undertakes an engagement to audit a single financial statement or a specific element of a financial statement, the auditor should, in accordance with paragraph .16 of AU-C section 805, issue a separate auditor's report and express a separate opinion for each engagement and indicate in the report on a specific element of a financial statement the date of the auditor's report on the complete set of financial statements and the nature of opinion expressed on those financial statements under an appropriate heading.

.08 An audited single financial statement or an audited specific element of a financial statement may be issued together, except as discussed later, with the entity's audited complete set of financial statements, provided that the presentation of the single financial statement or the specific element is sufficiently differentiated from the complete set of financial statements. The auditor should also differentiate the report on the single financial statement or the specific element of a financial statement from the report on the complete set of financial statements, as explained in paragraph .17 of AU-C section 805.

.09 If the auditor concludes that the presentation of the audited single financial statement or the audited specific element does not differentiate it sufficiently from the complete set of financial statements, the auditor should, in accordance with paragraph .18 of AU-C section 805, ask management to remedy the situation. The auditor should not release the auditor's report containing the opinion on the single financial statement or the specific element of a financial statement until satisfied with the differentiation.

.10 As described in paragraphs .19–.20 of AU-C section 805, if the opinion in the auditor's report on an entity's complete set of financial statements is modified, the auditor should determine the effect that this may have on the auditor's opinion on a single financial statement or a specific element of those financial statements.

.11 In the case of an audit of a specific element of a financial statement, if the auditor's modified opinion on the entity's complete set of financial statements as a whole is relevant to the audit of the specific element, the auditor should express an adverse opinion on the specific element when the modification of the auditor's opinion on the complete set of financial statements as a whole arises from a material misstatement in such financial statements. Alternately, the auditor should disclaim an opinion on the specific element when the modification of the auditor's opinion on the complete set of financial statements as a whole arises from an inability to obtain sufficient appropriate audit evidence.

.12 The auditor is not permitted to issue an unmodified opinion on an audited element of a financial statement with an entity's audited complete set of financial statements if the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole. An unmodified opinion on a specific element in the same auditor's report would contradict the adverse opinion or disclaimer of opinion on the entity's complete set of financial statements as a whole and would be tantamount to expressing a piecemeal opinion. In the context of a separate audit of a specific element that is included in those financial statements, when the auditor, nevertheless, considers it appropriate to express an unmodified opinion on that specific element, the auditor should only do so in accordance with paragraph .21 of AU-C section 805, if that opinion

- is expressed in an auditor's report that is neither issued together with, nor otherwise accompanies, the auditor's report containing the adverse opinion or disclaimer of opinion, and
- the specific element does not constitute a major portion of the entity's complete set of financial statements, or the specific element is not, or is not based upon, the entity's stockholders' equity or net income or the equivalent.

.13 As explained in paragraphs .22–.23 of AU-C section 805, a single financial statement is deemed to constitute a major portion of a complete set of financial statements. Therefore, the auditor should not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole, even if the auditor's report on the single financial statement is neither issued together with, nor otherwise accompanies, the auditor's report containing the adverse opinion or disclaimer of opinion.

.14 If the auditor's report on an entity's complete set of financial statements includes an emphasis-of-matter paragraph or an other-matter paragraph that is relevant to the audit of the single financial statement or the specific element, the auditor should include a similar emphasis-of-matter paragraph or an other-matter paragraph in the auditor's report on the single financial statement or the specific element.

.15 The auditor may be requested to audit an incomplete presentation but one that is otherwise in accordance with accounting principles generally accepted in the United States of America (GAAP). For example, an entity wishing to sell a division or product line may present certain assets and liabilities, revenues, and expenses relating to the division or product line being sold. Incomplete presentations may also be required by a regulatory agency or a contract or an agreement. For example, a regulatory agency may require a schedule of gross income and certain expenses of an entity's real estate operation in which income and expenses are measured in accordance with GAAP, but expenses are defined to exclude certain items, such as interest, depreciation, and income taxes. Also, an acquisition agreement may specify a schedule of gross assets and liabilities of the entity measured in accordance with GAAP but limited to the assets to be sold and liabilities to be transferred pursuant to the agreement. These types of presentations are generally regarded as single financial statements, even though certain items may be excluded only to the extent necessary to meet the purpose for which they were prepared. In order to avoid misunderstandings about the purpose for which the presentation is prepared, if the auditor reports on an incomplete presentation but one that is otherwise in accordance with GAAP, the auditor should include an emphasis-of-matter paragraph in the auditor's report that states the purpose for which the presentation is prepared and refers to a note in the financial statements that describes the basis of presentation and indicates that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues, or expenses.

[*The next page is 9701.*]

AAM Section 9130

Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements*
- AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication*
- AU-C section 935, *Compliance Audits*

AT Section:

- AT section 601, *Compliance Attestation*

.01 This section addresses the auditor's responsibility when the auditor is requested to report on an entity's compliance with aspects of contractual agreements or regulatory requirements, insofar as they relate to accounting matters, in connection with an audit of financial statements (referred to hereinafter as a *report on compliance*). Such a report is commonly referred to as a *by-product report*.

.02 Entities may be required by contractual agreements, such as certain bond indentures and loan agreements, or regulatory agencies to provide an auditor's report on compliance. For example, loan agreements may impose a variety of obligations on borrowers involving matters such as payments into sinking funds, payments of interest, maintenance of current ratios, and restrictions of dividend payments. Loan agreements may also require the borrower to provide annual financial statements that have been audited. In some instances, the lenders or their trustees may request the auditor to report that the borrower has complied with certain covenants of the agreement relating to accounting matters. The auditor may satisfy this request by issuing a report on compliance in accordance with the requirements of AU-C section 806.

.03 As described in the first paragraph, this section addresses reporting on an entity's compliance with aspects of contractual agreements or regulatory requirements in connection with an audit of financial statements. AU-C section 935 applies when the auditor is engaged or required by law or regulation to perform a compliance audit in accordance with generally accepted auditing standards (GAAS), the standards for financial audits under *Government Auditing Standards*, or a governmental audit requirement that requires the auditor to express an opinion on compliance with applicable compliance requirements. When the auditor is engaged to perform a separate attest engagement on an entity's compliance with requirements of specific laws, regulations, rules, contracts, or grants or the effectiveness of an entity 's internal control over compliance with specified requirements, AT section 601 applies.

.04 In accordance with paragraphs .07–.11 of AU-C section 806, the auditor's report on compliance should include a statement that nothing came to the auditor's attention that caused the auditor to believe that the entity failed to comply with specified aspects of the contractual agreements or regulatory requirements, insofar as they relate to accounting matters, only when

- the auditor has not identified any instances of noncompliance;
- the auditor has expressed an unmodified or qualified opinion on the financial statements to which the applicable covenants of such contractual agreements or regulatory requirements relate; and
- the applicable covenants or regulatory requirements relate to accounting matters that have been subjected to the audit procedures applied in the audit of financial statements.

.05 When the auditor has identified one or more instances of noncompliance, the report on compliance should describe such noncompliance.

.06 When the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor should issue a report on compliance only when instances of noncompliance are identified. Therefore, the requirement to describe the noncompliance also applies in such circumstances. The auditor should modify the wording of the report on compliance as appropriate to the circumstances.

.07 The auditor is not precluded from issuing a report on compliance if such report is required by another set of auditing standards (for example, *Government Auditing Standards*), and the auditor has been engaged to audit the financial statements in accordance with both GAAS and those other standards.

.08 The report on compliance should be in writing and should be provided either in a separate report or in one or more paragraphs included in the auditor's report on the financial statements.

Separate Report on Compliance With Aspects of Contractual Agreements or Regulatory Requirements

.09 In accordance with paragraph .12 of AU-C section 806, when the auditor reports on compliance in a separate report, the report should include the following:

- A title that includes the word "independent" to clearly indicate that it is the report of an independent auditor.
- An appropriate addressee.
- A paragraph that states that the financial statements were audited in accordance with GAAS and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards) and the date of the auditor's report on those financial statements.
- If the auditor expressed a modified opinion on the financial statements, a statement describing the nature of the modification.
- When no instances of noncompliance are identified by the auditor, a reference to the specific covenants or paragraphs of the contractual agreement or regulatory requirement and a statement that nothing came to the auditor's attention that caused the auditor to believe that the entity failed to comply with specified aspects of the contractual agreements or regulatory requirements, insofar as they relate to accounting matters.
- When instances of noncompliance are identified by the auditor, a reference to the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters, and a description of the identified instances of noncompliance.
- A statement that the report is being provided in connection with the audit of the financial statements.

- A statement that the audit was not directed primarily toward obtaining knowledge regarding compliance and, accordingly, had the auditor performed additional procedures, other matters may have come to the auditor's attention regarding noncompliance with the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters.
- A paragraph that includes a description and the source of significant interpretations, if any, made by the entity's management relating to the provisions of the relevant contractual agreement or regulatory requirement.
- A paragraph that includes an appropriate alert in accordance with the AU-C section 905.
- The manual or printed signature of the auditor's firm and the city and state where the auditor practices.
- The date of the report, which should be the same date as the auditor's report on the financial statements.

.10 When instances of noncompliance are identified and the entity has obtained a waiver for such noncompliance, the auditor may include a statement in the report on compliance that a waiver has been obtained. The determination of whether to include such a statement is based on the procedures performed by the auditor to evaluate the waiver for the purposes of obtaining sufficient appropriate audit evidence in connection with the audit of the financial statements. All instances of noncompliance are required to be described in the report on compliance, including those for which a waiver has been obtained.

Report on Compliance With Aspects of Contractual Agreements or Regulatory Requirements Included in the Auditor's Report

.11 In accordance with paragraph .13 of AU-C section 806, when a report on compliance is included in the auditor's report on the financial statements, the auditor's report should include an other-matter paragraph that includes a reference to the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters, and also should include the following:

- When no instances of noncompliance are identified by the auditor, a statement that nothing came to the auditor's attention that caused the auditor to believe that the entity failed to comply with specified aspects of the contractual agreements or regulatory requirements, insofar as they relate to accounting matters.
- When instances of noncompliance are identified by the auditor, a description of the identified instances of noncompliance.
- A statement that the communication is being provided in connection with the audit of the financial statements.
- A statement that the audit was not directed primarily toward obtaining knowledge regarding compliance, and accordingly, had the auditor performed additional procedures, other matters may have come to the auditor's attention regarding noncompliance with the specific covenants or paragraphs of the contractual agreement or regulatory requirement, insofar as they relate to accounting matters.
- A paragraph that includes a description and the source of significant interpretations, if any, made by the entity's management relating to the provisions of the relevant contractual agreement or regulatory requirement.
- A paragraph that includes an appropriate alert in accordance with AU-C section 905.

.12 An alert is necessary, whether or not the report is a separate report or included in the auditor's report, because although compliance matters may be identified by the auditor during the course of the audit engagement, the identification of such matters is not the primary objective of the audit engagement. In addition, the basis, assumptions, or purpose of the provisions in contractual agreements or regulatory requirements to which the report on compliance relates are developed for, and directed only to, the parties to the contractual agreement or the regulatory agency responsible for the requirements.

[*The next page is 9751.*]

AAM Section 9140

Engagements to Report on Summary Financial Statements

This section contains the following references from AICPA *Professional Standards*:

AU-C Sections:

- AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*
- AU-C section 730, *Required Supplementary Information*
- AU-C section 810, *Engagements to Report on Summary Financial Statements*

.01 This section addresses the auditor's responsibilities relating to an engagement to report separately on summary financial statements derived from financial statements audited in accordance with generally accepted auditing standards (GAAS) by the same auditor. In such an engagement, the auditor forms an opinion about whether the summary financial statements are consistent, in all material respects, with the audited financial statements from which they have been derived, in accordance with the applied criteria. AU-C section 810 applies to such engagements.

.02 Financial statements may present comparative information in the form of condensed financial statements or summarized financial information. For example, entities such as state and local governmental units may present prior period financial information in their government-wide financial statements only for the total reporting entity, rather than disaggregated by governmental activities, business-type activities, total primary government, and discretely presented component units. Also, not-for-profit organizations frequently present certain information for the prior period in total rather than by net asset class. This section does not apply to reporting on financial statements containing such comparative information. Summary financial statements differ from comparative information. Summary financial statements may be presented in a document containing financial statements or in a separate document, whereas comparative information is presented within the financial statements. Section 9100, "Comparative Financial Statements," addresses the auditor's responsibility for comparative information.

.03 Summary financial statements may be required by a designated accounting standards setter (for example, the Governmental Accounting Standards Board) to accompany the basic financial statements. This section does not apply in such circumstances. AU-C section 730 addresses the auditor's responsibilities relating to information supplementary to the basic financial statements that is required by a designated accounting standards setter to accompany such financial statements. Required supplementary information is discussed in section 9070, "Additional Communications in the Auditor's Report—Other-Matter Paragraphs."

.04 For purposes of this section, the following terms have the meanings attributed as follows:

Applied criteria. The criteria applied by management in the preparation of the summary financial statements.

Summary financial statements. Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time. Summary financial statements are separately presented and are not presented as comparative information.

Audited financial statements. Financial statements audited by the auditor in accordance with GAAS and from which the summary financial statements are derived.

.05 In accordance with paragraphs .08–.10 of AU-C section 810, the auditor should not accept an engagement to report on summary financial statements unless the auditor has been engaged to conduct an audit in accordance with GAAS of the financial statements from which the summary financial statements are derived. The audit of the financial statements from which the summary financial statements are derived provides the auditor with the necessary knowledge to discharge the auditor's responsibilities regarding the summary financial statements. Application of this section will not provide sufficient appropriate evidence on which to base the opinion on the summary financial statements if the auditor also has not audited the financial statements from which the summary financial statements are derived.

.06 Before accepting an engagement to report on summary financial statements, the auditor should

- determine whether the applied criteria are acceptable;
- obtain the agreement of management, in writing, that it acknowledges and understands its responsibilities; and
- obtain the agreement of management, in writing, about the expected form and content of the report on the summary financial statements, including the agreement that there may be circumstances in which the report may differ from its expected form and content.

.07 If the auditor concludes that the applied criteria are unacceptable or is unable to obtain the agreement of management described above, the auditor should not accept the engagement to report on the summary financial statements.

.08 The auditor should perform the following procedures as explained by paragraph .11 of AU-C section 810 and any other procedures that the auditor may consider necessary as the basis for the auditor's opinion on the summary financial statements:

- Evaluate whether the summary financial statements adequately disclose their summarized nature and identify the audited financial statements.
- When the summary financial statements are not accompanied by the audited financial statements, evaluate
  - — whether the summary financial statements clearly describe where the audited financial statements are available and
  - — whether the audited financial statements are readily available to the intended users of the summary financial statements.
- Evaluate whether the summary financial statements adequately disclose the applied criteria.
- Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with, or can be recalculated from, the related information in the audited financial statements.
- Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.
- Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary and are at an appropriate level of aggregation, so that they are not misleading in the circumstances.
- Request management's written representations in the form of a representation letter addressed to the auditor.

.09 The guidance on the forming of an opinion for engagements to report on summary financial statements resides in paragraphs .14–.16 of AU-C section 810. When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, the auditor's opinion should state that the summary financial statements are consistent, in all material respects, with the audited financial statements from which they have been derived, in accordance with the applied criteria.

.10 If the summary financial statements are not consistent, in all material respects, with the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor should express an adverse opinion on the summary financial statements. Due to the summarized nature of the summary financial statements, a qualified opinion would not be appropriate; the summary financial statements either are or are not consistent, in all material respects, with the audited financial statements, in accordance with the applied criteria.

.11 The auditor should state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the basis for adverse opinion paragraph, the summary financial statements are not consistent, in all material respects, with the audited financial statements from which they have been derived in accordance with the applied criteria.

.12 When the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion, the auditor should withdraw from the engagement to report on the summary financial statements, when withdrawal is possible under applicable law or regulation. If it is not possible for the auditor to withdraw from the engagement, the auditor's report on the summary financial statements should

- state that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion.
- describe the basis for that adverse opinion or disclaimer of opinion.
- state that, as a result of the adverse opinion or disclaimer of opinion, it is inappropriate to express, and the auditor does not express, an opinion on the summary financial statements.
- include the reporting elements described as follows except for
    - — if the date of the auditor's report on the summary financial statements is later than the date of the auditor's report on the audited financial statements, a statement that the summary financial statements and the audited financial statements do not reflect the effects of events, if any, that occurred subsequent to the date of the auditor's report on the audited financial statements.
    - — an indication that the summary financial statements do not contain all the disclosures required by the [*financial reporting framework applied in the preparation of the financial statements*] and that reading the summary financial statements is not a substitute for reading the audited financial statements.
    - — a statement of the auditor's responsibilities.
    - — a paragraph that clearly states an opinion.

.13 When an entity is required by law or regulation to provide a report on summary financial statements, the auditor is neither precluded from withdrawing, nor required to withdraw, from the engagement.

Elements of the Auditor's Report

.14 In accordance with paragraphs .17–.19 of AU-C section 810, the auditor's report on summary financial statements should include the following elements:

- Title that includes the word "independent" to clearly indicate that it is the report of an independent auditor
- Addressee

- Introductory paragraph that
  - identifies the summary financial statements on which the auditor is reporting, including the title of each statement included in the summary financial statements
  - identifies the audited financial statements from which the summary financial statements have been derived
  - refers to the auditor's report on the audited financial statements, the date of that report, and the fact that an unmodified opinion is expressed on the audited financial statements
  - if the date of the auditor's report on the summary financial statements is later than the date of the auditor's report on the audited financial statements, states that the summary financial statements and the audited financial statements do not reflect the effects of events, if any, that occurred subsequent to the date of the auditor's report on the audited financial statements
  - indicates that the summary financial statements do not contain all the disclosures required by the [*financial reporting framework applied in the preparation of the financial statements*] and that reading the summary financial statements is not a substitute for reading the audited financial statements
- Description of management's responsibility for the summary financial statements explaining that management is responsible for the preparation of the summary financial statements in accordance with the applied criteria
- Statement that the auditor is responsible for expressing an opinion about whether the summary financial statements are consistent, in all material respects, with the audited financial statements based on the procedures required by GAAS and an identification of the United States of America as the country of origin of those standards, including the following:
  - The procedures consisted principally of comparing the summary financial statements with the related information in the audited financial statements from which the summary financial statements have been derived and evaluating whether the summary financial statements are prepared in accordance with the applied criteria.
  - If the date of the auditor's report on the summary financial statements is later than the date of the auditor's report on the audited financial statements, the auditor did not perform any audit procedures regarding the audited financial statements after the date of the report on those financial statements.
- A paragraph that clearly expresses an opinion
- Auditor's signature
- Auditor's city and state
- Date of the auditor's report

.15 The auditor should date the auditor's report on the summary financial statements no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the opinion, including evidence that the summary financial statements have been prepared and that management and, when appropriate, those charged with governance, have asserted that they have taken responsibility for them, and the date of the auditor's report on the audited financial statements.

.16 When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements, the auditor may become aware of *subsequently discovered facts* as defined in AU-C section 560. In such cases, the auditor should not release the auditor's report on the summary financial statements until the auditor's consideration of subsequently discovered facts in relation to the audited financial statements, in accordance with AU-C section 560, has been completed.

Modifications to the Opinion, Emphasis-of-Matter Paragraph, or Other-Matter Paragraph in the Auditor's Report on the Audited Financial Statements

.17 If the auditor's report on the audited financial statements contains a qualified opinion, an emphasis-of-matter paragraph, or an other-matter paragraph, and the auditor expresses an unmodified opinion or an adverse opinion on the summary financial statements, in addition to the elements described previously, the auditor's report on the summary financial statements, as described in paragraph .20 of AU-C section 810, should

- state that the auditor's report on the audited financial statements contains a qualified opinion, an emphasis-of-matter paragraph, or an other-matter paragraph and
- describe
  - — the basis for the qualified opinion on the audited financial statements and that qualified opinion, or the emphasis-of-matter or other-matter paragraph in the auditor's report on the audited financial statements and
  - — the effect on the summary financial statements, if any.

Restriction on Use or Alerting Readers to the Basis of Accounting

.18 When use of the auditor's report on the audited financial statements is restricted or the auditor's report on the audited financial statements alerts readers that the audited financial statements are prepared in accordance with a special purpose framework, the auditor should, in accordance with paragraph .21 of AU-C section 810, include a similar restriction or alert in the auditor's report on the summary financial statements.

Comparatives

.19 As explained by paragraphs .22–.24 of AU-C section 810, if the audited financial statements contain comparative financial statements but the summary financial statements do not, the auditor should determine whether such omission is reasonable in the circumstances of the engagement. The auditor should determine the effect of an unreasonable omission on the auditor's report on the summary financial statements.

.20 If the summary financial statements contain comparatives that were not reported on by the auditor or another auditor, the auditor's report on the summary financial statements should state that the comparative summary financial statements were not reported on by the auditor and, accordingly, the auditor does not express an opinion on the comparative summary financial statements.

.21 If the summary financial statements contain comparatives that were reported on by another auditor, the auditor's report on the summary financial statements should (*a*) state that the summary financial statements of the prior period were audited by a predecessor auditor, (*b*) the type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons for the modification, and (*c*) the date of that report, unless the predecessor auditor's report on the prior period's summary financial statements is reissued with the summary financial statements.

Unaudited Information Presented With Summary Financial Statements

.22 As explained by paragraph .25 of AU-C section 810, the auditor should evaluate whether any unaudited information presented with the summary financial statements is clearly differentiated from the summary financial statements. If the auditor concludes that the entity's presentation of the unaudited information is not clearly differentiated from the summary financial statements, the auditor should ask management to change the presentation of the unaudited information. If management refuses to do so, the auditor should explain in the auditor's report on the summary financial statements that such information is not covered by that report and, accordingly, the auditor does not express an opinion on the information.

Other Information in Documents Containing Summary Financial Statements

.23 The auditor should, in accordance with paragraphs .25–.27 of AU-C section 810, read other information included in a document containing the summary financial statements and related auditor's report to identify material inconsistencies, if any, with the summary financial statements and the audited financial statements.

.24 If, upon reading the other information, the auditor identifies a material inconsistency or becomes aware of an apparent material misstatement of fact, the auditor should discuss the matter with management and should consider appropriate further action in the circumstances. For an identified material inconsistency, the auditor should also determine whether the summary financial statements or the other information needs to be revised.

Auditor Association

.25 In accordance with paragraphs .28–.29 of AU-C section 810, if the auditor becomes aware that the entity plans to state that the auditor has reported on summary financial statements in a document containing the summary financial statements but does not plan to include the related auditor's report, the auditor should request management to include the auditor's report in the document. If management does not do so, the auditor should determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document.

.26 The auditor may be engaged to report on the financial statements of an entity, while not engaged to report on the summary financial statements. If, in this case, the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that summary financial statements are derived from the financial statements audited by the auditor, the auditor should be satisfied that

- the reference to the auditor is made in the context of the auditor's report on the audited financial statements, and
- the statement does not give the impression that the auditor has reported on the summary financial statements.

.27 If either of the preceding criteria is not met, the auditor should request management to change the statement to meet both criteria or to not refer to the auditor in the document. Alternatively, the entity may engage the auditor to report on the summary financial statements and include the related auditor's report in the document. If management does not change the statement, delete the reference to the auditor, or include an auditor's report on the summary financial statements in the document containing the summary financial statements, the auditor should advise management that the auditor disagrees with the reference to the auditor, and the auditor should determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document.

.28 Other appropriate actions the auditor may take when management does not take the requested action may include informing the intended users and other known third-party users of the inappropriate reference to the auditor, including that the auditor did not report, and does not express an opinion on, the summary financial statements. The auditor's course of action depends on the auditor's association with misleading information and the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

[*The next page is 9801.*]

AAM Section 9150

Group Audits

This section contains the following reference from AICPA *Professional Standards*:

AU-C Section:

- AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

.01 Generally accepted auditing standards (GAAS) define *group audits* as the audit of group financial statements. This section addresses special reporting considerations that apply to group audits, in particular, those that involve component auditors. An auditor may find this section, adapted as necessary in the circumstances, useful when that auditor involves other auditors in the audit of financial statements that are not group financial statements. For example, an auditor may involve another auditor to observe the inventory count or inspect physical fixed assets at a remote location. AU-C section 600 applies to group audits.

.02 The group auditor would determine the significant components and then make a further decision about how to obtain sufficient appropriate audit evidence over those significant components. If the component is significant due to it size of financial significance, such procedures generally include an audit of the significant component, adapted as necessary to meet the requirements of the group auditor. A component auditor may be appointed by the group auditor, required by law or regulation, or may have been engaged by component management for another reason to express an audit opinion on the financial statements of a component. When a component auditor, separate from the group engagement team, is used by the group engagement partner, the group auditor would decide if it is appropriate to make reference to the component auditor in the group auditor's report or if it is appropriate for the group auditor to assume responsibility for the entire audit. The requirements of this section apply, nonetheless, regardless of whether the group engagement partner decides to make reference to the component auditor in the auditor's report on the group financial statements or to assume responsibility for the work of component auditors.

.03 Governmental entities frequently prepare group financial statements. The AICPA Audit and Accounting Guide *State and Local Governments* provides guidance to assist auditors in auditing and reporting on those financial statements in accordance with GAAS, including the requirements of this section.

Acceptance and Continuance

.04 Guidance related to acceptance and continuance of group audits is contained in paragraphs .14–.16 of AU-C section 600. The group engagement partner should determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained regarding the consolidation process and the financial information of the components on which to base the group audit opinion. For this purpose, the group engagement team should obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components.

.05 The group engagement partner should evaluate whether the group engagement team will be able to obtain sufficient appropriate audit evidence through the group engagement team's work or use of the work of component auditors (that is, through assuming responsibility for the work of component auditors or through making reference to the audit of a component auditor in the auditor's report) to act as the auditor of the group financial statements and report as such on the group financial statements.

.06 In some circumstances, the group engagement partner may conclude that it will not be possible, due to restrictions imposed by group management, for the group engagement team to obtain sufficient appropriate audit evidence through the group engagement team's work or use of the work of component auditors. The possible effect of this inability will result in a disclaimer of opinion on the group financial statements. In such circumstances, the auditor of the group financial statements should

- in the case of a new engagement, not accept the engagement, or, in the case of a continuing engagement, withdraw from the engagement when withdrawal is possible under applicable law or regulation or
- when the entity is required by law or regulation to have an audit, having performed the audit of the group financial statements to the extent possible, disclaim an opinion on the group financial statements.

Making Reference in the Auditor's Report

.07 The guidance related to making reference to component auditors is contained in paragraphs .25–.30 of AU-C section 600. The group engagement partner is responsible for deciding, individually for each significant component in which a component auditor was used, to either

- assume responsibility for and, thus, be required to be involved in, the work of a component auditor, insofar as that work relates to the expression of an opinion on the group financial statements or
- not assume responsibility for and, accordingly, make reference to, the audit of a component auditor in the auditor's report on the group financial statements.

.08 In group audits involving two or more component auditors, the decision to make reference to the audit of a component auditor is made individually for each component auditor, regardless of the decision whether to refer to any other component auditor. The auditor of the group financial statements may make reference to any, all, or none of the component auditors. For example, if significant components are audited by a component auditor from a network firm and one component is audited by another firm, the group engagement partner may decide to assume responsibility for the work of the component auditor from the network firm and make reference to the work of the component auditor from the other firm.

.09 Reference to the work of a component auditor in the auditor's report on the group financial statements should not be made unless

- the component's financial statements are prepared using the same financial reporting framework as the group financial statements;
- the component auditor has performed an audit on the financial statements of the component in accordance with GAAS or, when required by law or regulation, with auditing standards promulgated by the Public Company Accounting Oversight Board; and
- the component auditor has issued an auditor's report that is not restricted as to use.

.10 When the group engagement partner decides to make reference in the auditor's report on the group financial statements to the audit of a component auditor, the group engagement team should obtain sufficient appropriate audit evidence with regard to such components by performing the procedures required by AU-C section 600 and by reading the component's financial statements and the component auditor's report thereon to identify significant findings and issues and, when considered necessary, communicating with the component auditor in this regard.

.11 When the group engagement partner decides to make reference to the audit of a component auditor in the auditor's report on the group financial statements, the report on the group financial statements should clearly indicate that the component was not audited by the auditor of the group financial statements but was audited by the component auditor and should include the magnitude of the portion of the financial statements audited by the component auditor.

.12 The disclosure of the magnitude of the portion of the financial statements audited by a component auditor may be achieved by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly describes the portion of the financial statements audited by a component auditor. When two or more component auditors participate in the audit, the dollar amounts or the percentages covered by the component auditors may be stated in the aggregate.

.13 Reference in the auditor's report on the group financial statements to the fact that part of the audit was conducted by a component auditor is not to be construed as a qualification of the opinion but, rather, is intended to communicate that the auditor of the group financial statements is not assuming responsibility for the work of the component auditor, and the source of the audit evidence with respect to those components for which reference to the audit of component auditors is made.

.14 If the group engagement partner decides to name a component auditor in the auditor's report on the group financial statements, the component auditor's express permission should be obtained, and the component auditor's report should be presented together with that of the auditor's report on the group financial statements.

.15 If the opinion of a component auditor is modified or that report includes an emphasis-of-matter or other-matter paragraph, the auditor of the group financial statements should determine the effect that this may have on the auditor's report on the group financial statements. When deemed appropriate, the auditor of the group financial statements should modify the opinion on the group financial statements or include an emphasis-of-matter paragraph or an other-matter paragraph in the auditor's report on the group financial statements.

.16 If the modified opinion, emphasis-of-matter paragraph, or other-matter paragraph in the component auditor's report does not affect the report on the group financial statements and the component auditor's report is not presented, the auditor of the group financial statements need not make reference to those paragraphs in the auditor's report on the group financial statements. If the component auditor's report is presented, the auditor of the group financial statements may make reference to those paragraphs and their disposition.

.17 If the group engagement partner decides to assume responsibility for work of a component auditor, no reference should be made to the component auditor in the auditor's report on the group financial statements.

[*The next page is 10,001.*]

AAM Section 10,000
Quality Control

These sample quality control documents are presented for illustrative purposes only. They are intended as an aid for users of this manual who may want points of departure when establishing their own quality control policies and procedures. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants must consider the guidance in professional standards and should rely on their individual professional judgment in determining what may be needed in individual circumstances.

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AAM Section 10,100

Quality Control—General

AICPA Requirements

.01 ET section 57, *Article VI—Scope and Nature of Services* (AICPA, *Professional Standards*), of the AICPA's Code of Professional Conduct states that "members should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised." A firm must establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances. A system of quality control consists of policies designed to achieve these objectives and the procedures necessary to implement and monitor compliance with those policies.

.02 The AICPA issues Statements on Quality Control Standards (SQCSs) to establish standards and provide guidance to firms on establishing and maintaining a quality control system for their accounting and auditing practices. In November 2010, the AICPA issued SQCS No. 8, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10). SQCS No. 8 was effective as of January 1, 2012, and superseded extant SQCS No. 7. SQCS No. 7 superseded SCQS Nos. 2–6. SCQS No. 2 superseded SQCS No. 1.

.03 Presented in section 10,200 is *Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. Following the practice aid in section 10,300 are sample quality control forms to aid practitioners in implementing a quality control system.

[*The next page is 10,201.*]

AAM Section 10,200

Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice

NOTICE TO READERS

This AICPA Audit and Accounting Practice Aid updates *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, which was issued in 2007. This practice aid is intended to help practitioners better understand and apply Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10). That standard is included in appendix A of this practice aid. This version of the practice aid, prepared by the Quality Control Standards Task Force, has been revised to incorporate new policies and procedures that a firm should consider including in its system of quality control to be responsive to the issuance of SQCS No. 8. The policies and procedures presented in this practice aid are illustrative, and firms are encouraged to consider them in designing and maintaining a system of quality control that is appropriate for their accounting and auditing practices. Some of the policies and procedures presented in this practice aid are not required by the SQCSs; however, they represent the views of the task force regarding best practices for a quality control system. Although this practice aid has been reviewed by the AICPA Audit and Attest Standards staff, it has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA and has no official or authoritative status.

The Sarbanes-Oxley Act of 2002 (act) created the Public Company Accounting Oversight Board (PCAOB) and charged it with overseeing audits of issuers,[1] as defined by the act. Under the act, the PCAOB's duties include, among other things, establishing auditing, quality control, ethics, independence, and other standards relating to audits of issuers.

This practice aid does not address the quality control requirements of the act, nor does it address the quality control requirements of PCAOB standards that must be followed by auditors of issuers. Auditors of issuers should follow these other standards and make changes to their firm's quality control systems as necessary. Auditors of nonissuers who are engaged to report on audit engagements in accordance with PCAOB auditing standards also must report on those engagements in accordance with generally accepted auditing standards (GAAS). Paragraph .42 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), provides reporting guidance for audits of nonissuers when the auditor is asked to report in accordance with GAAS and PCAOB auditing standards.

Additional information about the PCAOB and the act can be obtained at the PCAOB website at www.pcaobus.org.

[1] Paragraph 7 of Section 2, "Definitions," of the Sarbanes-Oxley Act of 2002 states, "The term *issuer* means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c]), the securities of which are registered under section 12 of that act [15 U.S.C. 78l], or that is required to file reports under section 15(d) [15 U.S.C. 78o(d)], or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 [15 U.S.C. 77a et seq.], and that it has not withdrawn."

Quality Control Standards Task Force (2011)

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Chapter 1: Overview of Statements on Quality Control Standards

1.01 The objectives of a system of quality control are to provide a CPA firm with reasonable assurance[1] that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. SQCS No. 8, *A Firm's System of Quality Control (Redrafted)* (AICPA, *Professional Standards*, QC sec. 10), was issued by the Auditing Standards Board of the AICPA in November 2010 and is effective for a firm's accounting and auditing practice as of January 1, 2012. This standard supersedes SQCS No. 7, *A Firm's System of Quality Control*.

1.02 A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm's quality control policies and procedures will depend on various factors such as the firm's size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm's practice.

Communication of Quality Control Policies and Procedures

1.03 The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute, or make available electronically, them to all professional personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality
- A requirement for each individual to be familiar with and to comply with these policies and procedures

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm's management.

Elements of a System of Quality Control

1.04 A firm must establish and maintain a system of quality control. The firm's system of quality control should include policies and procedures that address each of the following elements of quality control identified in SQCS No. 8:

- Leadership responsibilities for quality within the firm (the "tone at the top")
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

1.05 The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures

[1] The term *reasonable assurance*, which is defined as a high, but not absolute, level of assurance, is used because absolute assurance cannot be attained. Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control (Redrafted)* (AICPA, *Professional Standards*, QC sec. 10), states, "Any system of quality control has inherent limitations that can reduce its effectiveness."

related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

1.06 Policies and procedures established by the firm related to each element are designed to achieve reasonable assurance with respect to the purpose of that element. Deficiencies in policies and procedures for an element may result in not achieving reasonable assurance with respect to the purpose of that element; however, the system of quality control, as a whole, may still be effective in providing the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances.

1.07 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm evaluates and, as necessary, revises, implements, and maintains firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

1.08 The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to achieve this purpose:

- Require the firm's leadership (managing partner, board of managing partners, CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control.
- Provide the firm with reasonable assurance that personnel assigned operational responsibility for the firm's quality control system have sufficient and appropriate experience and ability to identify and understand quality control issues and develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

1.09 Establishing and maintaining the following policies and procedures assists firms in recognizing that the firm's business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs:

- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Relevant Ethical Requirements

1.10 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.

- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.
- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.
- Require written confirmation, at least annually, of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant requirements.
- Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.[2]
- Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

Acceptance and Continuance of Client Relationships and Specific Engagements

1.11 The purpose of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- is competent to perform the engagement and has the capabilities, including the time and resources, to do so;
- can comply with legal and relevant ethical requirements;
- has considered the client's integrity and does not have information that would lead it to conclude that the client lacks integrity; and
- has reached an understanding with the client regarding the services to be performed.

1.12 This assurance should be obtained before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.[3]
- Evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.

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[2] A foreign-associated firm is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms.

[3] Such considerations would include the risk of providing professional services to significant clients or to other clients for which the practitioner's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a member or a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. Examples of factors to consider in determining the significance of a client to an engagement partner, office, or practice unit include (*a*) the amount of time the partner, office, or practice unit devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner, office, or practice unit is compensated, or (*d*) the effect that losing the client would have on the partner, office, or practice unit.

- Obtain an understanding, preferably in writing, with the client regarding the services to be performed.
- Establish procedures on continuing an engagement and the client relationship, including procedures for dealing with information that would have caused the firm to decline an engagement if the information had been available earlier.
- Require documentation of how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

Human Resources

1.13 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Recruit and hire personnel of integrity who possess the characteristics that enable them to perform competently.
- Determine capabilities and competencies required for an engagement, especially for the engagement partner, based on the characteristics of the particular client, industry, and kind of service being performed. Specific competencies necessary for an engagement partner are discussed in paragraph .A27 of SQCS No. 8.
- Determine the capabilities and competencies possessed by personnel.
- Assign the responsibility for each engagement to an engagement partner.
- Assign personnel based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.
- Have personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.
- Select for advancement only those individuals who have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

Engagement Performance

1.14 The purpose of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed.

1.15 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the engagement performance element of quality control:

- Plan all engagements to meet professional, regulatory, and the firm's requirements.
- Perform work and issue reports and other communications that meet professional, regulatory, and the firm's requirements.

- Require that work performed by other team members be reviewed by qualified engagement team members, which may include the engagement partner, on a timely basis.
- Require the engagement team to complete the assembly of final engagement files on a timely basis.
- Establish procedures to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.
- Require the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.
- Require that
  - — consultation take place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);
  - — sufficient and appropriate resources be available to enable appropriate consultation to take place;
  - — all the relevant facts known to the engagement team be provided to those consulted;
  - — the nature, scope, and conclusions of such consultations be documented; and
  - — the conclusions resulting from such consultations be implemented.
- Require that
  - — differences of opinion be dealt with and resolved;
  - — conclusions reached are documented and implemented; and
  - — the report not be released until the matter is resolved.
- Require that
  - — all engagements be evaluated against the criteria for determining whether an engagement quality control review should be performed;
  - — an engagement quality control review be performed for all engagements that meet the criteria; and
  - — the review be completed before the report is released.
- Establish procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.
- Establish criteria for the eligibility of engagement quality control reviewers.

Monitoring

1.16 The purpose of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports issued by the firm are appropriate in the circumstances

1.17 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the monitoring element of quality control:

- Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.
- Assign performance of the monitoring process to competent individuals.
- Require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures. Monitoring procedures consist of the following:
  - Review of selected administrative and personnel records pertaining to the quality control elements.
  - Review of engagement working papers, reports, and clients' financial statements.
  - Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate that improvements are needed.
  - Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
  - Communication of the identified findings to appropriate firm management personnel.
  - Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.
  - Assessment of
    - the appropriateness of the firm's guidance materials and any practice aids;
    - new developments in professional standards and regulatory and legal requirements and how they are reflected in the firm's policies and procedures where appropriate;
    - compliance with policies and procedures on independence;
    - the effectiveness of continuing professional development, including training;
    - decisions related to acceptance and continuance of client relationships and specific engagements; and
    - firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof.
- Communicate at least annually, to relevant engagement partners and other appropriate personnel, deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.
- Communicate the results of the monitoring of its quality control system process to relevant firm personnel at least annually.
- Establish procedures designed to provide the firm with reasonable assurance that it deals appropriately with the following. This includes establishing clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal and documenting complaints and allegations and the responses to them:
  - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements.
  - Allegations of noncompliance with the firm's system of quality control.
  - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.

- Require appropriate documentation to provide evidence of the operation of each element of its system of quality control. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following, for example:
  - — The size of the firm and the number of offices.
  - — The nature and complexity of the firm's practice and organization.
- Require retention of documentation providing evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

1.18 Some of the monitoring procedures discussed in the previous list may be accomplished through the performance of the following:

- Engagement quality control review
- Postissuance review of engagement working papers, reports, and clients' financial statements for selected engagements
- Inspection[4] procedures

Documentation of Quality Control Policies and Procedures

1.19 The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm's practice. Documentation may be as simple as a checklist of the firm's policies and procedures or as extensive as practice manuals.

Applying the Quality Control Standards to Four Hypothetical Firms

1.20 Subsequent chapters in this practice aid present four different hypothetical firms and the quality control policies and procedures each firm implements to address each of the quality control elements. Following is a description of those firms and their characteristics:

- Multioffice CPA Firm has 10 offices in 3 states and is centrally managed. It has approximately 15 partners and 100 professionals. Its accounting and auditing practice has a concentration of financial institution clients for which it performs audit and attest services. Multioffice CPA Firm has no issuer clients. (Chapter 2, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Firm With Multiple Offices")
- Singleoffice CPA Firm has 1 office, 3 partners, and 10 professionals. Its accounting and auditing practice has a concentration of employee benefit plan audits. Singleoffice CPA Firm has no issuer clients. (Chapter 3, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Firm With a Single Office")
- Sole Practitioner, CPA, is a sole owner who has no professional staff and occasionally hires per diem professionals. Her accounting practice consists only of engagements subject to Statements on Standards for Accounting and Review Services. (Chapter 4, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Sole Practitioner") (Note: Sole practitioners who perform audit and attest engagements should refer to chapter 3)
- Closely Aligned CPA Firm and Non-CPA-Owned Entity are organized in an *alternative practice structure*, which is a nontraditional structure in the practice of public accounting consisting of an attest and a nonattest portion of the practice. The attest portion is conducted through a firm, Closely Aligned CPA Firm, owned and controlled by CPAs. The nonattest portion is conducted through a

[4] *Inspection* is a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them. Although monitoring procedures are meant to be ongoing, they may include inspection procedures performed at a fixed point in time. Monitoring is a broad concept; inspection is one specific type of monitoring procedure.

separate entity, Non-CPA-owned Entity, owned and controlled by individuals who are not CPAs. (Chapter 5, "System of Quality Control for an Alternative Practice Structure")

1.21 The policies and procedures described in each chapter are those that a firm of a similar size and type may consider establishing and maintaining. The policies and procedures used by an actual firm need not necessarily include nor be limited to all those used by the illustrative firms.

Chapter 2: System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Firm With Multiple Offices

2.01 This chapter describes how a CPA firm that has multiple offices (Multioffice CPA Firm) implements each element of quality control in its accounting and auditing practice. Multioffice CPA Firm is a hypothetical firm that has 10 offices in 3 states and is centrally managed. Multioffice CPA Firm has 15 partners, 100 professionals, and a concentration of financial institution clients for which it performs audit and attest services. The firm uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. These practice aids are supplemented by oral and written communications from the firm's partners. It has no issuer clients.[1]

Quality Control Policies and Procedures

2.02 The firm's system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those polices. The policies and procedures are required to be documented. Multioffice CPA Firm documents its system of quality control by preparing a document that comprehensively describes policies and procedures established and maintained for each element of quality control. Multioffice CPA Firm reviews the documentation at least annually and updates it as necessary.

2.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

2.04 Multioffice CPA Firm communicates these policies and procedures in writing and makes the documentation available electronically to all professional personnel. Multioffice CPA Firm requires each individual to be familiar with and to comply with these policies and procedures. Multioffice CPA Firm also includes procedures for personnel to communicate their views or concerns on quality control matters to partners.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

2.05 The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Multioffice CPA Firm satisfies this purpose by establishing and maintaining the policies and procedures described in paragraphs 2.06–.10.

2.06 *Policy 1: The firm's managing partner assumes ultimate responsibility for the firm's system of quality control.* Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner accept overall responsibility for the firm's system of quality control and promoting a quality-oriented culture by sending clear, consistent, and frequent messages through e-mails, letters, and recordings
- Having a mission statement that includes the firm's core values and the importance of quality
- Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action

2.07 *Policy 2: The firm assigns management responsibilities so that commercial considerations do not override the quality of the work performed.* Multioffice CPA Firm implements this policy through the following procedures:

[1] If Multioffice CPA Firm were to be engaged to perform audit services for an issuer, it might need to revise its quality control policies and procedures to comply with Public Company Accounting Oversight Board standards and to reflect Securities and Exchange Commission requirements applicable to audits of issuers.

- Having the managing partner continually evaluate client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control
- Emphasizing to all personnel that fee considerations and scope of services should not infringe upon quality work

2.08 *Policy 3: The firm assigns operational responsibility for the firm's quality control system to personnel who have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating a quality control partner with overall operational responsibility for developing and implementing appropriate policies and procedures for the firm's quality control system
- Designating a quality control individual for each office

2.09 *Policy 4: The firm designs procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.* Multioffice CPA Firm implements this policy through the following procedures:

- Designing and implementing performance evaluation and advancement systems that (*a*) reward partners and staff involved in the accounting and auditing practice for the quality of their work and their compliance with professional standards and (*b*) include partner performance peer evaluations
- Establishing a compensation system that provides incentives to accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system does the following:
    - Takes into consideration firm feedback based on monitoring results and peer reviews of the work performed
    - Rewards partners and personnel for timely (*a*) identification of significant and emerging accounting and auditing issues and (*b*) consultation with firm experts

2.10 *Policy 5: The firm devotes sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.* Multioffice CPA Firm implements this policy through the following procedures:

- Providing the designated quality control partner with sufficient time, authority, and resources to develop, implement, and maintain the firm's quality control policies and procedures
- Providing the firm's quality control documentation to personnel when they are initially hired and reviewing the documentation with them
- Reviewing the firm's quality control policies and procedures with personnel at firm training sessions at least annually

Relevant Ethical Requirements

2.11 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Multioffice CPA Firm obtains this assurance by establishing and maintaining the policies and procedures described inparagraphs 2.12–.18.

2.12 *Policy 1: Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.* Multioffice CPA Firm implements this policy through the following procedures:

- Assigning one of its partners the responsibility of responding to questions, resolving matters, and determining the circumstances for which consultation with sources outside the firm is required for matters related to independence, integrity, and objectivity
- Identifying circumstances for which documentation of the resolution of matters is appropriate
- Maintaining a current list of (*a*) all entities with which firm personnel are prohibited from having a financial or business relationship and (*b*) all activities in which the firm is prohibited[2] from engaging, as defined in the firm's independence policies
- Establishing clear and concise written independence guidance covering relationships and activities that impair independence, including but not limited to investments, loans, brokerage accounts, business relationships, employment relationships, and fee arrangements

2.13 *Policy 2: The firm establishes procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.* Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner (through e-mails, letters, or recordings) emphasize the concepts of independence, integrity, and objectivity in the firm's professional development meetings, in the acceptance and continuance of clients and engagements, and in the performance of engagements. Because Multioffice CPA Firm has a concentration of financial institution clients, this also includes discussing the applicability of these concepts to engagements for financial institutions, such as the prohibition against any member of the engagement team having a "nongrandfathered" loan with the institution, and the types of nonattest services that could affect independence.
- Requiring periodic independence and ethics training for all professional personnel. Such training covers the firm's independence and ethics policies and the independence and ethics requirements of all applicable regulators.
- Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their independence or objectivity.
- Informing personnel on a timely basis of those entities to which independence policies apply by doing the following:
  - Preparing and maintaining a list of entities with which firm personnel are prohibited from having a financial or business relationship.
  - Making the list available to personnel so they may evaluate their independence (including personnel new to the firm or an office).
  - Notifying personnel of changes in the list.

2.14 *Policy 3: The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.* Multioffice CPA Firm implements this policy through the following procedures:

- Assigning a partner who is not otherwise associated with the engagement, or who practices in an office other than the office that performs the attest engagement, to review the engagement
- Requiring approval of the assignment of engagement personnel by another partner or manager
- Rotating engagement partners periodically
- Establishing additional procedures that provide safeguards when the firm performs audit or other attest work for (*a*) significant clients or (*b*) clients at which partners or other senior personnel are offered key management positions, or accept offers of employment, by utilizing the procedures

[2] Examples of prohibited activities include providing certain valuation and information technology services to an audit client. See the rules of specific standard-setters to determine the extent and relevance of any prohibition.

contained in paragraphs .01 and .04 of ET section 100-1, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*), of the AICPA Code of Professional Conduct

- Designating a senior-level partner to be responsible for overseeing the adequate functioning of the firm's independence policies
- Implementing a system to identify investment holdings of partners and managers that might impair independence
- Requiring all professionals to report, on a timely basis when identified, apparent violations of independence, integrity, or objectivity policies involving themselves, their spouses, or their dependents and the corrective actions taken or proposed to be taken
- Establishing a requirement for all professional personnel to notify the managing partner in each office of any potential activities that might impair independence or violate ethics rules, including services provided to entities with which firm personnel are prohibited from having a business relationship
- Establishing a program that protects professional personnel who report potential ethics or independence violations to the proper parties in compliance with firm policy
- Requiring the managing partner in each office, or a person designated by the managing partner, to periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence
- Developing guidance that sets forth the consequences for professional personnel who violate the firm's independence policies and procedures, including engaging in activities with entities with which firm personnel are prohibited from having a business relationship
- Requiring all professional personnel to review the list of entities with which firm personnel are prohibited from having a business relationship before a professional or the spouse or dependent of a professional obtains a security or financial interest in an entity
- Establishing criteria that determine the need for safeguards for engagements where monitoring procedures or peer review have identified weaknesses in previous years or the same senior personnel have been used for five years or more on an audit or attestation engagement
- Documenting any safeguards applied to eliminate threats to independence or reduce them to an acceptable level
- Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to (*a*) the engagement partner who, with the firm, needs to address the breach and (*b*) other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action
- Obtaining confirmation from the engagement partner and other relevant personnel that the required corrective actions have been taken

2.15 *Policy 4: The firm withdraws from engagements if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.* Multioffice CPA Firm implements this policy through the following procedures:

- Consulting within the firm and, if necessary, with legal counsel and other parties when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied
- Withdrawing from engagements when effective safeguards to reduce threats to independence to an acceptable level cannot be applied

2.16 *Policy 5: The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements.* Multioffice CPA Firm implements this policy through the following procedures:

- Obtaining written representations from personnel, upon hire and on an annual basis, stating that they have read the firm's independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation (such written representations are accompanied by the most current list of all entities with which firm personnel are prohibited from having a financial or business relationship)
- Assigning responsibility to the firm's quality-control partner for obtaining such written representations, reviewing independence compliance files for completeness, and resolving reported exceptions
- Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement

2.17 *Policy 6: The firm establishes procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of an engagement.* Multioffice CPA Firm implements this policy through the following procedures:

- Describing in its policies and procedures manual the form and content of independence representations, and frequency with which they are to be obtained
- Requiring that such representations be documented

2.18 *Policy 7: The firm rotates personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.* Multioffice CPA Firm implements this policy by having the quality control partner monitor regulatory requirements for financial institutions and other entities and notifying partners of the need for rotation. Multioffice CPA Firm has decided to rotate partners assigned to audit financial institutions every five years.

Acceptance and Continuance of Client Relationships and Specific Engagements

2.19 The purpose of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- is competent to perform the engagement and has the capabilities, including the time and resources, to do so;
- can comply with legal and relevant ethical requirements;
- has considered the client's integrity and does not have information that would lead it to conclude the client lacks integrity; and
- has reached an understanding with the client regarding the services to be performed.

2.20 Multioffice CPA Firm obtains this assurance, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the policies and procedures described in paragraphs 2.21–.25.

2.21 *Policy 1: The firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.* Multioffice CPA Firm implements this policy through the following procedures:

- Developing and maintaining a manual that contains policies and procedures related to the acceptance of prospective clients and the continuance of existing clients. Such policies and procedures state that the firm's clients should not present undue risks to the firm, including damage to the firm's reputation.

- Advising professional personnel that they are expected to be familiar with the firm's policies and procedures for the acceptance and continuance of clients.
- Obtaining and evaluating relevant information before accepting or continuing any client. The following are examples of such information:
    - The nature and purpose of the services to be provided and management's understanding thereof.
    - The identity of the client's principal owners, key management, related parties, and those charged with its governance.
    - The nature of the client's operations, including its business practices, from sources such as annual reports, interim financial statements, reports to regulators, enforcement actions by regulators, and income tax returns.
    - Information obtained from inquiries of third parties about the client, its principal owners, key management, and those charged with governance that may have a bearing on evaluating the client. Examples of such third parties are bankers, factors, legal counsel, credit services, investment bankers, underwriters, and other members of the financial or business community who may have applicable knowledge. Inquiries also might be made regarding management's attitude toward compliance with regulators or legislative requirements and the presence of control deficiencies, especially those that management is unwilling to correct.
- Communicating with the predecessor accountant or auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of any disagreements and whether there is evidence of opinion shopping.
- Assessing management's commitment to implementing and maintaining effective internal control.
- Assessing management's commitment to the appropriate application of generally accepted accounting principles (GAAP).
- Conducting a background check of the business, its officers, and the person(s) in question by using an investigative firm and evaluating the information obtained regarding management's integrity. Background checks are conducted when the firm is unable to obtain sufficient information about the prospective client after completing the steps listed previously, or when there is an indication that management or someone affiliated with the prospective client may be less than reputable.
- Evaluating the risk of providing services to significant clients or to other clients for which the firm's independence or the appearance of independence may be impaired. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (*a*) the amount of time the partner devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner is compensated, and (*d*) the effect that losing the client would have on the partner and the firm.

2.22 *Policy 2: The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.* Multioffice CPA Firm implements this policy through the following procedures:

- Evaluating whether the following are in place:
    - The practice office has sufficient personnel who have obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.

- Specialists are available if needed, through, for example, the resources of another practice office or alternative source.
- The firm is able to complete the engagement within the reporting deadline.

- Defining high-risk engagements.
- Specifying conditions that trigger the requirement between annual audits to reevaluate a client or engagement. The following are examples of such conditions:
  - Significant changes in the client, such as a major change in ownership, senior client personnel, directors, advisers, the nature of the business, or its financial stability.
  - Changes in the nature or scope of the engagement, such as an initial public offering or a request to step down from an audit to a review engagement.
  - Changes in the composition or strategic focus of the firm, such as the inability to replace the loss of key personnel who are particularly knowledgeable about a specialized industry or a decision by Multioffice CPA firm to discontinue services to clients in a particular industry.
  - The existence of conditions that would have caused the firm to reject the engagement had such conditions existed at the time of the initial acceptance, such as aggressive earnings management, unreliable processes for developing accounting estimates, questionable estimates by management, questions regarding the entity's ability to continue as a going concern, and other factors that may increase the risk of being associated with the client.
  - The client's delinquency in paying fees. (This may also affect the firm's independence.)
  - Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, governmental entities, and employee benefit plans.
  - Engagements for entities in the development stage.
  - Engagements in which the client has ignored prior recommendations, such as recommendations that address deficiencies in internal control.
- Obtaining relevant information to determine whether the relationship should be continued and establishing the frequency with which client continuance evaluations should be made.
- Evaluating the information obtained regarding acceptance or continuance of a client or engagement through the following activities:
  - The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the firm, and makes a recommendation about whether the client or engagement should be accepted or continued.
  - The engagement partner completes a client acceptance form and submits it to the managing partner of the practice office for approval.
  - The engagement partner signs a step in the planning program noting that he or she has considered whether the client should be continued, and if conditions exist that trigger the requirement between annual audits to reevaluate a client or engagement, prepares a form documenting his or her rationale and conclusion regarding client continuance.
  - The partner responsible for the quality control function assesses and approves the recommendation made by the engagement partner. In certain defined circumstances, such as high-risk engagements, acceptance or continuance decisions also may require approval of the firm's managing partner.
- Establishing procedures for dealing with information that would have caused the firm to decline the engagement if the information had been available earlier.

2.23 *Policy 3: The firm obtains an understanding with the client regarding the services to be performed.* Multioffice CPA Firm implements this policy by requiring that for all engagements, the firm prepare a written engagement letter documenting the understanding with the client and obtain the client's signature on that letter, thus minimizing the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed.

2.24 *Policy 4: The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.* Multioffice CPA Firm implements this policy through the following procedures:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal
- Discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement, or from both the engagement and the client relationship, if the firm determines that it is appropriate to withdraw

2.25 *Policy 5: The firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.* Multioffice CPA Firm implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

2.26 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Multioffice CPA Firm obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 2.27–.33.

2.27 *Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently.* Multioffice CPA Firm implements this policy by maintaining firm-wide hiring standards and evaluating the firm's personnel needs, including the following:

- Designating a partner or other qualified individual in each office to be responsible for evaluating the overall personnel needs in that practice office and establishing hiring objectives based on factors such as existing clientele, anticipated growth, personnel turnover, and individual advancement
- Developing and maintaining personnel policies and procedures that identify attributes, achievements, and experiences desired in entry-level and experienced personnel
- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Establishing guidelines for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions
- Preparing budgets that identify personnel needs at all levels
- Identifying sources of employment candidates such as universities and executive recruiters
- Selecting and training the individuals who will be interviewing candidates or otherwise participating in the hiring process

- Summarizing and evaluating the results of the hiring process for each candidate, including approval by the managing partner, or a person designated by the managing partner, of all hiring decisions

2.28 *Policy 2: The firm determines capabilities and competencies required for an engagement, including those required of the engagement partner.* Multioffice CPA Firm implements this policy by specifying the competencies that the engagement partner for an accounting, auditing, or attest engagement (or other person responsible for supervising and signing or authorizing someone to sign the firm's report on such engagements) should possess. Such competencies include having an understanding of the following:

- The role of the firm's system of quality control and the AICPA Code of Professional Conduct, both of which play critical roles in ensuring the integrity of the accounting, auditing, and attest function to users of reports.
- The performance, supervision, and reporting aspects of the engagement, which ordinarily are gained through training or participation in similar engagements.
- The industry in which the client operates, including its organization and operating characteristics, sufficient to identify areas of high or unusual risk associated with the engagement and to evaluate the reasonableness of industry-specific estimates.
- The professional standards applicable to the engagement being performed and to the industry in which the client operates. Such standards include accounting, auditing, and attestation standards, as well as rules and regulations issued by applicable regulators.
- The skills that contribute to sound professional judgment, including the ability to exercise professional skepticism.
- How the organization uses information technology and the manner in which information systems are used to record and maintain financial information.

2.29 *Policy 3: The firm determines the capabilities and competencies possessed by personnel.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Evaluating personnel at least annually to determine their capabilities and competencies

2.30 *Policy 4: The firm assigns responsibility for each engagement to an engagement partner.* Multioffice CPA Firm implements this policy through the following procedures:

- Assigning the responsibility for each engagement to an engagement partner who has the appropriate capabilities, competence, authority, and time to perform the role
- Clearly defining and communicating the responsibilities of the partner to the engagement partner
- Communicating the identity and role of the partner to management and those charged with governance
- Developing and maintaining systems to monitor the workload and availability of engagement partners to enable these individuals to have sufficient time to adequately discharge their responsibilities

2.31 *Policy 5: The firm assigns personnel (including partners) based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating an appropriate person(s) in each office to be responsible for assigning personnel to engagements based on such factors as the following:
  - Engagement type, size, significance, complexity, and risk profile

- — Specialized experience or expertise required and competencies gained through previous experience or education
- — Need for and availability of staff and supervisors
- — Timing of the work to be performed
- — Continuity and rotation of personnel
- — Opportunities for on-the-job training
- — Situations for which independence or objectivity concerns exist

- Designating a partner to be responsible for partner and manager assignments
- Requiring approval of partner and manager assignments from the industry partner or the quality assurance partner in the case of high-risk or significant client engagements
- Establishing a policy for monitoring the continuation and rotation of engagement partners

2.32 *Policy 6: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other applicable regulators.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating a partner to oversee the development of firm requirements and materials for a professional development program covering subjects relevant to the firm's clients and services. Such responsibilities include the following:
  - — Encouraging personnel to pass the Uniform CPA Examination
  - — Establishing guidelines for participation by personnel in professional development programs and considering the requirements of the AICPA, state boards of accountancy, and applicable regulators in establishing the firm's CPE requirements
  - — Maintaining appropriate documentation evidencing that personnel have met the professional education requirements of the firm, the AICPA, state boards of accountancy, and other applicable regulators
  - — Providing an orientation program and training for new personnel to inform them of their professional responsibilities and firm policies
  - — Preparing and providing publications and programs to inform personnel of their responsibilities and opportunities
  - — Developing in-house staff training programs that focus on general and industry-specific accounting and auditing subjects, including audits of financial institutions
- Communicating and distributing to personnel changes in accounting, auditing, attestation, and quality control standards, as well as independence, integrity, and objectivity requirements and the firm's guidance with respect to those standards and requirements
- Encouraging professional personnel at each level in the firm to participate in external professional development activities such as the following:
  - — CPE courses
  - — Meetings of professional organizations
  - — Serving on professional committees
  - — Writing for professional publications
  - — Speaking to professional groups

2.33 *Policy 7: Personnel selected for advancement have the qualifications necessary to fulfill the responsibilities they will be called on to assume.* Multioffice CPA Firm implements this policy through the following procedures:

- Appointing a director of human resources to identify and communicate, in the firm's policies and procedures manual, the qualifications necessary to accomplish responsibilities at each professional level in the firm. This includes the following:
  - Establishing criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give recognition and reward to the development and maintenance of competence and commitment to ethical principles.
  - Developing evaluation forms for each professional staff classification, including partners. Such forms include evaluation of performance quality and adherence to ethical principals.
  - Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.
- Assigning responsibility to a partner for making advancement and termination decisions for staff and recommendations to the firm's management committee for manager and partner-level advancement and termination. Such responsibilities include the following:
  - Identifying responsibilities and requirements for evaluation at each level and indicating who will prepare these evaluations and when they will be prepared
  - Reviewing evaluations on a timely basis with the individual being evaluated
- Advising personnel regarding their progress and career opportunities through the following procedures:
  - Evaluating employees annually and at the end of each assignment exceeding three weeks to provide feedback on performance.
  - Summarizing and reviewing with personnel their performance evaluations, including assessing their progress with the firm, at least annually. Considerations include past performance, future objectives of the firm and the individual, assignment preferences, and career opportunities.
  - Evaluating partners periodically by means of performance reviews, peer evaluations, or self-appraisals, as appropriate, to provide feedback and to determine whether they continue to have the qualifications to accomplish their assigned responsibilities and to assume additional responsibilities.

Engagement Performance

2.34 The purpose of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Multioffice CPA Firm obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 2.35–.45.

2.35 *Policy 1: Planning for engagements meets professional, regulatory, and the firm's requirements.* Multioffice CPA Firm implements this policy by developing, maintaining, and providing personnel with the firm's policies and procedures manual that delineates the factors the engagement team should consider in the planning process and the extent of documentation of these considerations. Planning considerations may vary depending on the size and complexity of the engagement. Planning generally includes the following activities:

- Assigning responsibility to the engagement partner for planning the engagement and assigning responsibilities to appropriate personnel during the planning phase
- Developing or updating background information about the client
- Considering client significance to the firm
- Requiring, for all initial audit clients designated as high risk by the firm, an independent review of planning considerations by either the engagement quality control reviewer or another partner
- Requiring planning documentation that includes the following:
  - Proposed work programs tailored to the specific engagement
  - Staffing requirements, including the need for personnel with specialized knowledge who may have to be obtained from other practice offices
  - Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement
  - Consideration of risks and how they may affect the procedures to be performed
  - A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the firm's quality control policies and procedures
  - Evidence of review of planning by an independent review partner

2.36 *Policy 2: The engagement is performed, supervised, reviewed, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm.* Multioffice CPA Firm implements this policy by requiring personnel to comply with the firm's policies and procedures manual, which prescribes the following:

- How engagement teams are supervised during the course of an engagement, including briefing the engagement team on the objectives of their work
- The form and content of documentation of the work performed and conclusions reached, including forms, checklists, and questionnaires to be used in performing engagements
- The form in which instructions are to be given to other offices or other auditors performing part of an engagement and the extent to which such work is to be reviewed and documented
- The extent of overall engagement review required, at all professional levels, to ensure that the financial statements meet professional and firm presentation and disclosure requirements
- The extent of review to be performed of required communications to management and the board of directors

2.37 *Policy 3: Qualified engagement team members review work performed by other team members on a timely basis.* Multioffice CPA Firm implements this policy through the following procedures:

- Adhering to the following firm guidelines regarding review of documentation of the work performed and conclusions reached, the financial statements, and reports and documentation of the review process:
  - All reviewers are to possess appropriate experience, competence, authority, and responsibility and are to be given access to the firm's reference material and other resources.
  - For each engagement, there is to be appropriate documentation evidencing review of the documentation of the work performed and conclusions reached, the financial statements, and the report.
- Assigning responsibility for the review of all reports, financial statements, and documentation of the work performed and conclusions reached to an appropriate reviewer in accordance with procedures outlined in the firm's manual to obtain reasonable assurance of the following:

- — The nature, timing, and extent of procedures performed are consistent with risk assessments and the approach described in the planning documentation. Exceptions are appropriately investigated. The appropriateness of planned procedures should be reconsidered if significant changes in risk factors occur or are identified between the planning phase of the engagement and the execution of procedures.
- — Firm-prescribed forms, checklists, and questionnaires, tailored as appropriate, are used in performing and reporting on the engagement.

- Requiring a second review, by a partner or manager, of the report, financial statements, and selected documentation of the work performed and conclusions reached, as prescribed in the firm's policies and procedures manual. The extent of review varies based on the type of engagement. For example, engagements for financial institutions, high-risk engagements, and those performed for significant clients, as defined by the firm, receive an engagement quality control review.
- Reviewing engagement documentation to determine whether the following has occurred:
  - — The work has been performed in accordance with professional standards and regulatory and legal requirements.
  - — Significant findings and issues have been raised for further consideration.
  - — Appropriate consultations have taken place, and the resulting conclusions have been documented and implemented.
  - — The nature, timing, and extent of work performed are appropriate and do not need revision.
  - — The work performed supports the conclusions reached and is appropriately documented.
  - — The evidence obtained is sufficient and appropriate to support the report.
  - — The objectives of the engagement procedures have been achieved.

2.38 *Policy 4: Engagement teams complete the assembly of final engagement files on a timely basis.* Multioffice CPA Firm implements this policy by completing the assembly of final engagement files in accordance with professional standards and applicable regulatory requirements, if any.

2.39 *Policy 5: The firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing and applying controls to accomplish the following:
  - — Clearly determine when and by whom engagement documentation was prepared and reviewed.
  - — Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means.
  - — Prevent unauthorized changes to the engagement documentation.
  - — Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.
- Requiring the use of a password by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users.
- Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Implementing procedures for properly distributing engagement documentation materials to the team members at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement.

- Implementing procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
    - — Generate scanned copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
    - — Integrate the scanned copies into the engagement files, including indexing and signing off on the copies as necessary.
    - — Enable the scanned copies to be retrieved and printed as necessary.

2.40 *Policy 6: The firm retains engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing procedures that accomplish the following:
    - — Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time.
    - — Provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed.
    - — Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.
- Retaining documentation for a specific period of time as appropriate for the nature of the engagement.

2.41 *Policy 7: The firm requires that consultation take place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented.* Multioffice CPA Firm implements this policy through the following procedures:

- Providing personnel with the firm's policies and procedures manual that specifies the firm's consultation policies and procedures. Areas or specialized situations for which the firm requires consultation include the following:
    - — Application of newly issued technical pronouncements.
    - — Industries with special accounting, auditing, or reporting requirements.
    - — Emerging practice problems.
    - — Choices among alternative GAAP upon initial adoption or when an accounting change is made.
    - — Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the date a report was issued.
    - — Filing requirements of regulators.
    - — Meetings with regulators at which the firm is to be called upon to support the application of GAAP or generally accepted auditing standards that have been questioned.
    - — Designating individuals within the firm as consultants in certain areas. Personnel are to consult with the designated individual when issues arise. If differences arise between the engagement partner and the consultant, the matter is to be resolved by the partner(s) responsible for the quality control function.

- Maintaining or providing access to adequate and up-to-date references, which includes materials related to specific industries, specialties, and regulatory requirements, in each office.
- Requiring that documentation of consultation include all relevant facts and circumstances, the sections of the professional literature used in making a determination, the conclusion reached, how the conclusions were implemented, and the signatures of the engagement partner and consultant. This documentation is to be retained with the engagement documentation of the work performed and conclusions reached. At the discretion of the consultant, the documentation may be entered in a retrievable database to promote efficiencies in the consultation process and consistency in the resolution of similar issues.

2.42 *Policy 8: The firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved.* Multioffice CPA Firm implements this policy through the following procedures:

- Requiring that all differences of professional judgment within an engagement team be resolved by the engagement and quality control partners, and the managing partner if necessary, and that the report not be released until the matter is resolved.
- Requiring that the resolution of the differences be appropriately documented. If members of the engagement team continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

2.43 *Policy 9: The firm has criteria for determining whether an engagement quality control review should be performed; evaluates all engagements against the criteria; performs an engagement quality control review for all engagements that meet the criteria; and completes the review before the report is released.* Multioffice CPA Firm implements this policy by defining high-risk engagements and requiring that an engagement quality control review be performed for all high-risk engagements, engagements for financial institutions, and engagements performed for significant clients.

2.44 *Policy 10: The firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.* Multioffice CPA Firm implements this policy through the following procedures:

- Implementing procedures addressing the timing of the review. The firm has concluded that performing an engagement quality control review is not necessary to obtain sufficient appropriate audit evidence for audit engagements; therefore, the engagement quality control review does not need to be completed before the date of the auditor's report but is required to be completed before the report is released. When the engagement quality control review results in additional audit procedures being performed, the date of the auditor's report is changed to the date by which sufficient appropriate audit evidence has been obtained.
- Implementing procedures addressing the nature and extent of the review. The firm's procedures for audit and attestation engagements require that the engagement quality control reviewer do the following:
    - — Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.
    - — Discuss with the engagement partner the engagement team's identification and audit of high-risk assertions, transactions, and account balances.
    - — Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.
    - — Review documentation of the resolution of significant accounting, auditing, and financial reporting issues, including documentation of consultation with firm personnel or external sources.

- Review the summary of uncorrected misstatements that are related to known and likely misstatements.
- Review additional engagement documentation to the extent considered necessary.
- Read the financial statements and report and consider whether the report is appropriate.
- Confirm with the engagement partner that there are no significant unresolved issues.
- Complete the review before the release of the report.
- Determine whether the issues raised in the review indicate a need to change the auditor's report date.

- Resolving conflicting opinions between the engagement partner and the engagement quality control reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.
- Implementing procedures addressing documentation by the engagement quality control reviewer. The firm's procedures require documentation of the following:
  - That the procedures required by the firm's policies on engagement quality control review have been performed.
  - That the engagement quality control review has been completed before the report is released.
  - That no matters have come to the attention of the engagement quality control reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

2.45 *Policy 11: The firm establishes criteria for the eligibility of engagement quality control reviewers.* Multioffice CPA Firm implements this policy by establishing the following criteria for an engagement quality control reviewer:

- Is not selected by the engagement partner
- Has sufficient technical expertise and experience
- Carries out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the engagement partner and the engagement quality control reviewer
- Does not assume any of the responsibilities of the engagement partner or have responsibility for the audit of any significant subsidiaries, divisions, benefit plans, or affiliated or related entities
- Meets the independence requirements relating to the engagements reviewed, even though the engagement quality control reviewer is not a member of the engagement team
- Does not make decisions for the engagement team or participate in the performance of the engagement, except that the engagement partner may consult the engagement quality control reviewer at any stage during the engagement

Monitoring

2.46 The purpose of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented

- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

2.47 Multioffice CPA Firm obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 2.48–.51.

2.48 *Policy 1: The firm assigns responsibility for the monitoring process to a partner and assigns performance of the monitoring process to competent individuals.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating a partner with appropriate authority to be responsible for quality assurance, including ensuring that the firm's quality control policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include the following:
  - Mergers and divestitures of portions of the practice.
  - Changes in professional standards and other regulatory requirements applicable to the firm's practice.
  - Results of inspections and peer reviews.
  - Reviews of litigation and regulatory enforcement actions against the firm and others.
  - Changes in applicable AICPA membership requirements.
- Preparing inspection checklists and guidance materials or using materials prepared by the AICPA for performing inspection procedures.
- Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality in performing their duties.
- Identifying the need to take the following actions:
  - Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed.
  - Improve compliance with firm policies and procedures related to the other elements of quality control.
- Assigning performance of the monitoring process to the designated quality control individual for each practice office.

2.49 *Policy 2: The firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.* Multioffice CPA Firm implements this policy through the following procedures:

- Developing and performing the firm's inspection program to obtain feedback about the effectiveness of the firm's policies and procedures.
- Reviewing the resolution of matters reported by professional personnel on independence-confirmation forms to determine that matters have been appropriately considered and resolved.
- Interviewing personnel at all professional management and staff levels to obtain information about operating procedures in practice offices, whether personnel are knowledgeable about firm policies and procedures, and whether such policies and procedures are being effectively communicated.
- Reviewing the following documentation to determine compliance with firm policies and procedures:
  - Personnel evaluations, including documentation of hiring and advancement decisions.
  - Documentation of client acceptance and continuance decisions.
  - Participants' evaluations of practice office training programs.
  - Professional development records of personnel.

  - Correspondence regarding the resolution of independence matters within the practice office.
- Developing a plan to test a sample of engagements for compliance with the firm's policies and procedures. Such a review may be preissuance or postissuance.
- Reviewing a cross-section of engagements from selected practice offices using the following criteria for inclusion in the sample selected:
  - Engagements involving all partners and managers who have significant accounting and auditing responsibilities in the selected offices.
  - Engagements for financial institutions.
  - First-year engagements.
  - Significant client engagements.
  - Specialized industries, with emphasis given to high-risk industries.
  - Level of service performed (audit, review, compilation, and attestation).
  - Level of attestation services performed (examination, review, and agreed-upon procedures).
  - Engagements for which there have been complaints or allegations that the work performed by the firm fails to comply with professional standards, regulatory requirements, or the firm's system of quality control.
  - Engagements in which there were significant disagreements between the quality review partner and the engagement partner.
- Periodically reviewing the process for personnel evaluation and counseling to ascertain the following:
  - Procedures for evaluation and documentation are being followed on a timely basis.
  - Personnel who have been promoted have achieved the applicable requirements for advancement.
  - Personnel decisions are consistent with evaluations.
  - Recognition is given to outstanding performance.
- Designating a partner or qualified individual in each office to review the summary of the evaluations of in-house training programs to determine whether the programs are achieving their objectives.
- Designating a partner or qualified individual in each office to review summaries of CPE records for that office's professional staff to determine that the office has established a means of tracking each individual's compliance with the requirements of the AICPA and other applicable regulators.
- Interviewing selected professional personnel regarding the effectiveness of training programs.
- Considering the results of the firm's inspection as they relate to the effectiveness of the firm's professional development program.
- Ascertaining whether inquiries received by individuals consulted within the firm indicate the need for additional CPE programs.
- Reviewing and updating firm practice aids, such as audit programs, forms, and checklists, to reflect new or revised professional pronouncements.
- Issuing guidance regarding new professional standards, regulatory requirements, and related changes to firm policy.
- Soliciting comments from partners and managers regarding the effectiveness of practice aids and tools.

2.50 *Policy 3: The firm communicates at least annually (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its quality control system process to relevant firm personnel.* Multioffice CPA Firm implements this policy through the following procedures:

- Preparing a summary monitoring report for the firm's senior management that evaluates the overall results of the inspection and other monitoring procedures and reaches final conclusions regarding whether the firm as a whole needs to improve compliance with the firm's policies and procedures and whether revisions to the firm's quality control policies and procedures are necessary.
- Communicating findings to practice office personnel and determining the corrective actions to be taken for the engagements reviewed. These findings are discussed and communicated in a report issued to each office. The practice office responds regarding the specific corrective actions or steps to be taken to improve compliance with the firm's policies and procedures and professional standards.
- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).
- Communicating in partner-manager meetings and firm policy correspondence the need for changes in the system of quality control.
- Communicating in training programs, partner-manager meetings, and firm policy correspondence the need for improved compliance with the system of quality control.

2.51 *Policy 4: The firm deals appropriately with complaints and allegations.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing procedures for concerns to be brought to the attention of the ethics committee in a confidential manner
- Having the firm's ethics committee (excluding any members who are otherwise involved in the engagement under investigation) investigate the following:
  - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  - Allegations of noncompliance with the firm's system of quality control
  - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Consulting with legal counsel as necessary
- Documenting complaints and allegations and the responses to them

2.52 *Policy 5: The firm prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.* Multioffice CPA Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of quality control, including the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected
- A record of the evaluation of the following:
  - Adherence to professional standards and regulatory and legal requirements
  - Whether the quality control system has been appropriately designed and effectively implemented
  - Whether the firm's quality control policies and procedures have been appropriately applied

- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

2.53 *Policy 6: The firm retains documentation providing evidence of the operation of the system of quality control for an appropriate period of time.* Multioffice CPA Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

Chapter 3: System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Firm With a Single Office

3.01 This chapter describes how a CPA firm that has a single office (Singleoffice CPA Firm) implements each element of quality control in its accounting and auditing practice. Singleoffice CPA Firm is a hypothetical firm with 1 office, 3 partners, and a total of 10 professionals. Its accounting and auditing practice has a concentration of employee benefit plans, and the firm has no issuer clients.[1] The firm uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. These practice aids are supplemented by oral and written communications from the firm's partners.

Quality Control Policies and Procedures

3.02 The firm's system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those polices. The policies and procedures are required to be documented. Singleoffice CPA Firm documents its system of quality control by preparing a document that comprehensively describes the policies and procedures for each element of quality control. Singleoffice CPA Firm reviews the documentation at least annually and updates it as necessary.

3.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

3.04 Singleoffice CPA Firm communicates these policies and procedures in writing and makes the documentation available electronically to all professional personnel. Singleoffice CPA Firm requires each individual to be familiar with and to comply with these policies and procedures. Singleoffice CPA Firm encourages its personnel to communicate their views or concerns about quality control matters to partners.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

3.05 The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Singleoffice CPA Firm satisfies this purpose by establishing and maintaining the policies and procedures described in paragraphs 3.06–.10.

3.06 *Policy 1: The firm's managing partner assumes ultimate responsibility for the firm's system of quality control.* Singleoffice CPA Firm implements this policy through the following procedures:

- Having the managing partner accept ultimate responsibility for the firm's system of quality control and for setting a tone that emphasizes the importance of quality and of following the firm's system of quality control
- Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action

3.07 *Policy 2: Commercial considerations do not override the quality of the work performed.* Singleoffice CPA Firm implements this policy through the following procedures:

- Having the managing partner continually evaluate client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control

[1] If Singleoffice CPA Firm were to be engaged to perform audit services for an issuer, it might need to revise its quality control policies and procedures to comply with Public Company Accounting Oversight Board standards and to reflect Securities and Exchange Commission requirements applicable to audits of issuers.

- Emphasizing to all personnel that fee considerations and scope of services should not infringe upon quality work

3.08 *Policy 3: Responsibility for developing, implementing, and operating the firm's quality control system is assigned to personnel with sufficient and appropriate experience, authority, and ability.* Singleoffice CPA Firm implements this policy by having the managing partner designate a quality control partner who is responsible for designing, implementing, and monitoring the firm's quality control system.

3.09 *Policy 4: Performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel demonstrate the firm's overarching commitment to the objectives of the system of quality control.* Singleoffice CPA Firm implements this policy through the following procedures:

- Designing and implementing performance evaluation and advancement systems that reward partners and staff involved in the accounting and auditing practice for the quality of their work and their compliance with professional standards.
- Establishing a compensation system that provides incentives to accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system does the following:
  - Takes into consideration firm feedback based on monitoring results and peer reviews of the work performed.
  - Rewards partners and personnel for timely (*a*) identification of significant and emerging accounting and auditing issues and (*b*) consultation with firm experts.

3.10 *Policy 5: The firm devotes sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.* Singleoffice CPA Firm implements this policy through the following procedures:

- Providing the designated quality control partner with sufficient time, authority, and resources to develop, implement, and maintain the firm's quality control policies and procedures
- Providing the firm's quality control documentation to personnel when they are initially hired and reviewing the documentation with them
- Reviewing the firm's quality control policies and procedures with personnel at firm training sessions at least annually

Relevant Ethical Requirements

3.11 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Singleoffice CPA Firm obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 3.12–.17.

3.12 *Policy 1: Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.* Singleoffice CPA Firm implements this policy through the following procedures:

- Designating a quality assurance partner to review relevant pronouncements relating to independence, integrity, and objectivity; answer questions; determine the circumstances for which consultation with sources outside the firm is required; and resolve matters
- Providing personnel with access to the AICPA *Professional Standards* service
- Establishing a system for identifying all services performed for each client and evaluating whether any of those services might impair independence

3.13 *Policy 2: The firm establishes procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.* Singleoffice CPA Firm implements this policy through the following procedures:

- Informing personnel of those entities to which independence policies apply by doing the following on a timely basis:
  - Preparing and maintaining a list of entities with which firm personnel are prohibited from having a financial or business relationship
  - Making the list available to personnel so they may evaluate their independence (including personnel new to the firm)
  - Notifying personnel of changes in the list
- Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their independence or objectivity

3.14 *Policy 3: The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.* Singleoffice CPA Firm implements this policy through the following procedures:

- Requiring the engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall impact, if any, on independence requirements.
- Accumulating and communicating relevant information to appropriate personnel so that the following can occur:
  - The firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements.
  - The firm can maintain and update information relating to independence.
  - The firm and the engagement partner can take appropriate action regarding identified threats to independence.
- Requiring personnel to promptly report circumstances and relationships that create a threat to independence, and independence breaches of which they become aware, so that appropriate action can be taken.
- Establishing criteria to determine the need for safeguards for engagements where the following have taken place:
  - Monitoring procedures or peer review has identified weaknesses in previous years.
  - The same senior personnel have been used for five years or more on an audit or attestation engagement.
- Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to the following personnel:
  - The engagement partner who, with the firm, needs to address the breach.
  - Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.
- Requiring the engagement partner and the other individuals referred to in the previous list to confirm to the firm that the required corrective actions have been taken.
- Having a partner, or an individual designated by the partner, periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence.

- Establishing additional procedures that provide safeguards when the firm performs audit or other attest work for (*a*) significant clients or (*b*) clients at which partners or other senior personnel are offered key management positions or have accepted offers of employment.

3.15 *Policy 4: The firm withdraws from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.* Singleoffice CPA Firm implements this policy through the following procedures:

- Consulting within the firm, and with legal counsel and other parties if necessary, when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied
- Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied

3.16 *Policy 5: The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements.* Singleoffice CPA Firm implements this policy through the following procedures:

- Obtaining written representations from personnel, upon hire and on an annual basis, stating that they have read the firm's independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation. (Such written representations are accompanied by the most current list of all entities with which firm personnel are prohibited from having a business relationship.)
- Reviewing these independence representations for completeness and resolving reported exceptions.
- Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement.

3.17 *Policy 6: The firm establishes procedures for confirming the independence of another firm that performs part of the engagement.* Singleoffice CPA Firm implements this policy through the following procedures:

- Using practice aids that prescribe the form and content of independence representations, and frequency with which they are to be obtained
- Requiring that such representations be documented

Acceptance and Continuance of Client Relationships and Specific Engagements

3.18 The purpose of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- is competent to perform the engagement and has the capabilities, including the time and resources, to do so;
- can comply with legal and ethical requirements;
- has considered the client's integrity and does not have information that would lead it to conclude that the client lacks integrity; and
- has reached an understanding with the client regarding the services to be performed.

3.19 Singleoffice CPA Firm obtains this assurance, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the policies and procedures described in paragraphs 3.20–.24.

3.20 *Policy 1: The firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.* Singleoffice CPA Firm implements this policy through the following procedures:

- Informing personnel of the firm's policies and procedures for accepting and continuing clients, including those outlined in the firm's practice aids.
- Obtaining and evaluating relevant information such as the following before accepting or continuing a client:
  - — The nature and purpose of the services to be provided and management's understanding thereof.
  - — The identity of the client's principal owners, key management, related parties, and those charged with its governance.
  - — Information obtained from inquiries of the client's bankers, factors, attorneys, credit services, and others who have business relationships with the entity.
  - — The nature of the client's operations, including its business practices, from sources such as annual reports, interim financial statements, reports to and from regulators, income tax returns, and credit reports.
  - — Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting.
- Evaluating the risk of providing services for the following engagements:
  - — Engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and employee benefit plans.
  - — Engagements that require an inordinate amount of time to complete relative to the available resources of the firm.
- Communicating with the predecessor accountant or auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of any disagreements and whether there is evidence of opinion-shopping.
- Conducting a background check of the business, its officers, and the person(s) in question by using the services of an investigative company and evaluating the information obtained regarding management's integrity. Background checks are conducted when the firm is unable to obtain sufficient information about the prospective client after taking the steps described previously, or there is an indication that management or someone affiliated with the prospective client may be less than reputable.
- Evaluating the risk of providing services to significant clients or to other clients for which the firm's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (*a*) the amount of time the partner devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner is compensated, and (*d*) the effect that losing the client would have on the partner and the firm.

3.21 *Policy 2: The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.* Singleoffice CPA Firm implements this policy through the following procedures:

- Evaluating whether the firm has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
- Evaluating whether the following are in place:
  - — The firm has sufficient personnel with the necessary capabilities and competence.
  - — Specialists are available if needed.
  - — Individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, when needed.
  - — The firm is able to complete the engagement within the reporting deadline.
- Specifying conditions that trigger the requirement to reevaluate a specific client or engagement. The following are examples of such conditions:
  - — Significant changes in the client, such as a major change in senior client personnel, ownership, advisers, the nature of its business, or the financial stability of the client.
  - — Changes in the nature or scope of the engagement, including requests for additional services.
  - — Changes in the composition of the firm, such as the loss of and inability to replace key personnel who are particularly knowledgeable about a specialized industry.
  - — The decision to discontinue services to clients in a particular industry.
  - — The existence of conditions that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance.
  - — The client's delinquency in paying fees. (This may also affect the firm's independence.)
  - — Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, governmental entities, and employee benefit plans.
  - — Engagements for entities in which there may be substantial doubt about the entity's ability to continue as a going concern.
  - — Engagements in which the client has ignored prior recommendations, such as those that address deficiencies in internal control.
- Obtaining relevant information to determine whether the relationship should be continued and establishing a frequency for evaluations (for example, continuance decisions are made at least annually).
- Evaluating the information obtained regarding acceptance or continuance of the client or engagement through the following activities:
  - — The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the firm, and makes a recommendation about whether the client or engagement should be accepted or continued.
  - — The engagement partner completes a client acceptance form and submits it to the managing partner for approval.
  - — The engagement partner signs a step in the planning program noting consideration of client continuance and completes a form documenting the rationale and conclusion regarding client continuance if conditions exist that trigger the requirement to reevaluate a client or engagement between annual audits.
  - — The managing partner assesses and approves the recommendation made by the engagement partner. If the managing partner recommends not accepting a client or discontinuing

a client relationship, the managing partner discusses his or her reasons for the acceptance or continuance decision with the other partners.

- Establishing procedures for dealing with information that would have caused the firm to decline the engagement if the information had been available earlier.

3.22 *Policy 3: The firm obtains an understanding with the client regarding the services to be performed.* Singleoffice CPA Firm implements this policy by requiring that, for all engagements, the firm prepare a written engagement letter documenting the understanding with the client and obtain the client's signature on that letter, thus minimizing the risk of misunderstanding regarding the nature, scope, and limitations of the services to be performed.

3.23 *Policy 4: The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.* Singleoffice CPA Firm implements this policy through the following procedures:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal
- Discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship if the firm determines that it is appropriate to withdraw

3.24 *Policy 5: The firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.* Singleoffice CPA Firm implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

3.25 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Singleoffice CPA Firm obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 3.26–.32.

3.26 *Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently.* Singleoffice CPA Firm implements this policy through the following procedures:

- Designating an individual in the firm to be responsible for the following activities:
  - Managing the human resources function
  - Evaluating the firm's personnel needs by considering factors such as existing clientele, anticipated growth, personnel turnover, and individual advancement
  - Developing criteria for determining which individuals will be involved in the interviewing and hiring process
- Establishing an understanding among the partners about the attributes, achievements, and experiences desired in entry-level and experienced personnel
- Setting guidelines for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions

3.27 *Policy 2: The firm determines capabilities and competencies required for an engagement, including those required of the engagement partner.* Singleoffice CPA Firm implements this policy by specifying the competencies that the engagement partners of the firm's accounting, auditing, and attestation engagements (or other persons responsible for supervising and signing or authorizing someone to sign the firm's report on such engagements) should possess. These competencies include having an understanding of the following:

- The role of the firm's system of quality control and the AICPA Code of Professional Conduct in ensuring the integrity of the accounting, auditing, and attest functions to users of reports.
- The performance, supervision, and reporting aspects of the engagement, which ordinarily are gained through training or participation in similar engagements.
- The industry in which the client operates, including its organization and operating characteristics, sufficient to identify areas of high or unusual risk associated with the engagement and to evaluate the reasonableness of industry-specific estimates.
- The professional standards applicable to the engagement and the industry in which the client operates. Such standards include accounting, auditing, and attestation standards, as well as rules and regulations issued by applicable regulators.
- The skills that contribute to sound professional judgment, including the ability to exercise professional skepticism.
- How the organization uses information technology and the manner in which information systems are used to record and maintain financial information.

3.28 *Policy 3: The firm determines the capabilities and competencies possessed by personnel.* Singleoffice CPA Firm implements this policy through the following procedures:

- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Evaluating personnel at least annually to determine their capabilities and competencies

3.29 *Policy 4: The firm assigns the responsibility for each engagement to an engagement partner.* Singleoffice CPA Firm implements this policy through the following procedures:

- Assigning responsibility for each engagement to an engagement partner who has the appropriate capabilities, competence, authority, and time to perform the role
- Clearly defining and communicating the responsibilities of the partner to the engagement partner
- Communicating the identity and role of the partner to management and those charged with governance
- Monitoring the workload and availability of engagement partners to enable these individuals to have sufficient time to adequately discharge their responsibilities

3.30 *Policy 5: The firm assigns personnel (including partners) based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.* Singleoffice CPA Firm implements this policy through the following procedures:

- Designating an appropriate person to be responsible for assigning personnel to engagements based on such factors as the following:
    - — Engagement type, size, significance, complexity, and risk profile
    - — Specialized experience and expertise required for the engagement and competencies gained through prior experience
    - — Personnel availability
    - — Timing of the work to be performed

- — Continuity and rotation of personnel
- — Opportunities for on-the-job training
- — Situations for which independence or objectivity concerns exist

- Designating a partner to be responsible for partner and manager assignments
- Requiring approval of partner and manager assignments from the managing partner or other partner in the case of high-risk or significant client engagements

3.31 *Policy 6: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other regulators.* Singleoffice CPA Firm implements this policy through the following procedures:

- Encouraging personnel to pass the Uniform CPA Examination
- Assigning responsibility to a partner to maintain a professional development program that does the following:
  - — Requires personnel to participate in professional development programs in accordance with firm guidelines and in subjects that are relevant to their responsibilities
  - — Takes into account the requirements of the AICPA, state boards of accountancy, and other regulatory agencies in establishing the firm's CPE requirements
  - — Provides CPE course materials to, and maintains records of completed CPE for, professional personnel
  - — Provides an orientation and training program for new hires
- Encouraging participation by personnel at each level in the firm in other professional development activities such as completing external professional development programs, including graduate-level and self-study courses, becoming members of professional organizations, serving on professional committees, writing for professional publications, and speaking to professional groups
- Communicating and distributing to personnel, when applicable, changes in accounting, auditing, attestation, and quality control standards, as well as independence requirements and the firm's guidance with respect to those standards and requirements

3.32 *Policy 7: Personnel selected for advancement have the qualifications to fulfill the responsibilities they will be called on to assume.* Singleoffice CPA Firm implements this policy through the following procedures:

- Assigning responsibility to the three partners to jointly make advancement and termination decisions. Such responsibilities include the following:
  - — Establishing criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give recognition and reward to the development and maintenance of competence and commitment to ethical principles.
  - — Informing firm personnel about the criteria for advancement to the next higher level of responsibility.
  - — Designating personnel responsible for preparing evaluations and determining when they should be prepared.
  - — Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.
  - — Using forms that include the applicable qualifications when evaluating the performance of personnel. Such forms include qualifications related to performance quality and adherence to ethical principles.

— Reviewing evaluations on a timely basis with the individual being evaluated.

- Counseling personnel regarding their progress and career opportunities by doing the following:
  - — Evaluating employees annually and at the end of each assignment lasting four weeks or longer to provide feedback on performance.
  - — Summarizing and reviewing with personnel annually the evaluation of their performance, including an assessment of their progress with the firm. Considerations include past performance, future objectives of the individual and the firm, the individual's assignment preferences, and career opportunities.
  - — Evaluating partners periodically by means of counseling, peer evaluation, or self-appraisal, as appropriate.

Engagement Performance

3.33 The purpose of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Singleoffice CPA Firm obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 3.34–.44.

3.34 *Policy 1: Planning for engagements meets professional, regulatory, and the firm's requirements.* Singleoffice CPA Firm implements this policy by maintaining and providing personnel with the firm's practice aids that prescribe the factors the engagement team should consider in the planning process and the extent of documentation of those considerations. Planning considerations may vary depending on the size and complexity of the engagement. Planning generally includes the following activities:

- Assigning responsibilities to appropriate personnel during the planning phase
- Developing or updating background information on the client and the engagement
- Considering client significance to the firm
- Developing a planning document that includes the following:
  - — Proposed work programs tailored to the specific engagement
  - — Staffing requirements and the need for specialized knowledge
  - — Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement
  - — The risks, including fraud considerations, affecting the client and the engagement and how the risks may affect the procedures performed
  - — A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the firm's quality control policies and procedures

3.35 *Policy 2: The engagement is performed, supervised, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm.* Singleoffice CPA Firm implements this policy through the following procedures:

- Providing adequate supervision during the course of an engagement, including briefing the engagement team on the objectives of their work. The training, ability, and experience of the personnel are considered when assigning supervisors to the engagement.

- Requiring that a written work program be used in all engagements.
- Addressing significant issues arising during the engagement, considering their significance, and appropriately modifying the planned approach.
- Adhering to the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached. Such documentation includes standardized forms, checklists, and questionnaires used in the performance of engagements and explanations, when required, of how the firm integrates such aids into engagements.
- Requiring engagement documentation in accordance with professional standards, applicable regulatory requirements, and the firm's policies.

3.36 *Policy 3: Qualified engagement team members review work performed by other team members on a timely basis.* Singleoffice CPA Firm implements this policy by adhering to the following guidelines established by the firm regarding review of the documentation of the work performed and conclusions reached, the financial statements and reports, and documentation of the review process:

- All reviewers are to have appropriate experience, competence, and responsibility.
- For each engagement, there is to be evidence of appropriate review of documentation of the work performed and conclusions reached, the financial statements, and the report.
- Engagement documentation is reviewed to determine whether the following have occurred:
  - The work has been performed in accordance with professional standards and regulatory and legal requirements.
  - Significant findings and issues have been raised for further consideration.
  - Appropriate consultations have taken place, and the resulting conclusions have been documented and implemented.
  - The nature, timing, and extent of work performed are appropriate and do not need revision.
  - The work performed supports the conclusions reached and is appropriately documented.
  - The evidence obtained is sufficient and appropriate to support the report.
  - The objectives of the engagement procedures have been achieved.

3.37 *Policy 4: Engagement teams complete the assembly of final engagement files on a timely basis.* Singleoffice CPA Firm implements this policy by completing the assembly of final engagement files in accordance with professional standards and applicable regulatory requirements, if any.

3.38 *Policy 5: The firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.* Singleoffice CPA Firm implements this policy through the following procedures:

- Establishing and applying controls to accomplish the following:
  - Clearly determine when and by whom engagement documentation was prepared and reviewed.
  - Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means.
  - Prevent unauthorized changes to the engagement documentation.
  - Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.
- Implementing procedures for properly distributing engagement documentation materials to engagement teams at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement.

- Implementing procedures to restrict access to, and enable proper distribution and confidential storage of, hardcopy engagement documentation.
- Requiring the use of passwords by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users.
- Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
  - Generate copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
  - Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
  - Enable the copies to be retrieved and printed as necessary.

3.39 *Policy 6: The firm retains engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.* Singleoffice CPA Firm implements this policy through the following procedures:

- Retaining engagement documentation for a period of time sufficient to meet the requirements of the state board of accountancy and applicable professional standards.
- Establishing procedures that
  - enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time;
  - provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed; and
  - enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

3.40 *Policy 7: The firm requires that consultation take place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented.* Singleoffice CPA Firm implements this policy through the following procedures:

- Consulting with those having appropriate knowledge, authority, and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical, and other matters. Singleoffice CPA firm uses advisory services provided by other firms, professional and regulatory bodies, and commercial organizations that provide relevant quality control services. Before using such services, the firm evaluates whether the external provider is qualified for that purpose.
- Informing personnel of the firm's consultation policies and procedures.
- Requiring sufficiently experienced engagement team members to identify matters for consultation or consideration during the engagement.
- Requiring consultation in specialized areas or situations with appropriate individuals within and outside the firm when matters such as the following arise:
  - The application of newly issued technical pronouncements.
  - Industries with special accounting, auditing, or reporting requirements, including unusually complex employee benefit plans.

   - Emerging practice problems.
   - Choices among alternative generally accepted accounting principles (GAAP) upon initial adoption or when an accounting change is made.
   - Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the date a report was issued.
   - Filing requirements of regulators.
   - Meetings with regulators at which the firm is to be called on to support the application of GAAP or generally accepted auditing standards that have been questioned.
- Providing all professional personnel with access to adequate and current reference materials.
- Including all relevant facts, circumstances, the professional literature used, and conclusions reached in the engagement documentation of the work performed and conclusions reached.
- Documenting the issue on which consultation was sought and the results of the consultation, including any decisions taken, the basis for those decisions, and how they were implemented. If there is an unresolved disagreement, an outside source may be consulted to assist in determining the appropriate application of accounting principles.

3.41 *Policy 8: The firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved.* Singleoffice CPA Firm implements this policy through the following procedures:

- Requiring that all differences of professional judgment among members of an engagement team be resolved by the engagement and the quality control partners, and the managing partner if necessary, and that the report not be released until the matter is resolved.
- Requiring that conclusions reached be appropriately documented. If members of the team continues to disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

3.42 *Policy 9: The firm has criteria for determining whether an engagement quality control review should be performed, evaluates all engagements against the criteria, performs an engagement quality control review for all engagements that meet the criteria, and completes the review before the report is released.* Singleoffice CPA Firm implements this policy through the following procedures:

- Establishing criteria such as the following:
   - The identification of unusual circumstances or risks in an engagement or class of engagements as determined by the engagement partner or quality control partner
   - An engagement quality control review is required by law or regulation
- Evaluating all engagements against the criteria
- Performing an engagement quality control review for all engagements that meet the criteria

3.43 *Policy 10: The firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.* Singleoffice CPA Firm implements this policy through the following procedures:

- Implementing procedures addressing the nature, timing, and extent of the review. The firm has concluded that performing an engagement quality control review is not necessary to obtain sufficient appropriate audit evidence for audit engagements; therefore, the engagement quality control review does not need to be completed before the date of the auditor's report. When the engagement quality control review results in additional audit procedures being performed, the date of the auditor's report is changed to the date by which sufficient appropriate audit evidence has been obtained. The firm's procedures require that for audit and attestation engagements, the engagement quality control reviewer do the following:

- — Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.
- — Discuss with the engagement partner the engagement team's identification and audit of high-risk assertions, transactions and account balances.
- — Confirm with the engagement partner that there are no significant unresolved issues.
- — Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.
- — Review documentation of the resolution of significant accounting, auditing, or financial reporting issues, including documentation of consultation with firm personnel or external sources.
- — Review the summary of uncorrected misstatements related to known and likely misstatements.
- — Review additional engagement documentation to the extent considered necessary.
- — Read the financial statements and the report and consider whether the report is appropriate.
- — Complete the review before the release of the report. The review may be conducted at appropriate stages during the engagement.
- — Determine whether the issues raised in the review indicate a need to change the auditor's report date.

- Resolving conflicting opinions between the engagement partner and the engagement quality control reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.
- Implementing procedures addressing documentation by the engagement quality control reviewer. The firm's procedures require documentation of the following:
  - — The procedures required by the firm's policies on engagement quality control review have been performed.
  - — The engagement quality control review has been completed before the report is released.
  - — No matters have come to the attention of the engagement quality control reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

3.44 *Policy 11: The firm establishes criteria for the eligibility of engagement quality control reviewers.* Singleoffice CPA Firm implements this policy by establishing the following criteria for an engagement quality control reviewer:

- Is selected by the quality control partner or the managing partner
- Has sufficient technical expertise and experience
- Carries out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the audit engagement partner and the engagement quality control reviewer
- Meets the independence requirements relating to the engagements reviewed, even though the engagement quality control reviewer is not a member of the engagement team
- Does not make decisions for the engagement team or participate in the performance of the engagement except that the engagement partner may consult the engagement quality control reviewer at any stage during the engagement

When the firm does not have suitably qualified personnel to perform the engagement quality control review, the firm contracts with a suitably qualified external person to perform the engagement quality control review.

Monitoring

3.45 The purpose of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

3.46 Singleoffice CPA Firm obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 3.47–.56.

3.47 *Policy 1: The firm assigns responsibility for the monitoring process, including performance, to a partner or competent individual.* Singleoffice CPA Firm implements this policy through the following procedures:

- Designating a partner or senior personnel to be responsible for quality assurance, including ensuring that the firm's quality control policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include the following:
    - Mergers and divestitures of portions of the practice.
    - Changes in professional standards or other regulatory requirements applicable to the firm's practice.
    - Results of inspections and peer reviews.
    - Review of litigation and regulatory enforcement actions against the firm and its personnel.
    - Changes in applicable AICPA membership requirements.
- Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality in performing their duties.
- Identifying the need to do the following:
    - Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed.
    - Improve compliance with firm policies and procedures related to the other elements of quality control.

3.48 *Policy 2: The firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.*

3.49 For purposes of illustrating Policy 2, two scenarios are described. Scenario 1 illustrates how Singleoffice CPA Firm would satisfy the objective of Policy 2 by reviewing engagements throughout the year. Scenario 2 illustrates how Singleoffice CPA Firm would implement Policy 2 by performing an annual inspection, thereby reviewing engagements during a designated period in the year.

3.50 *Scenario 1: Monitoring by Reviewing Engagements Throughout the Year.* Singleoffice CPA Firm implements Policy 2 through the following procedures:

- Designating a partner or management-level individual not previously associated with the engagement to perform either a preissuance or postissuance review of the engagement.

- Establishing the approach for performing preissuance or postissuance reviews, for example, the comprehensiveness of the review and the frequency for summarizing findings (such as monthly or quarterly). The comprehensiveness of the review of selected engagements is similar to that performed in an inspection or peer review.
- Designating the forms and checklists to be used during the engagement and functional element reviews and the extent of the documentation required. (Examples of functional elements are the human resources function and the firm's library.)
- Selecting a cross-section of engagements at the beginning of the monitoring year for preissuance or postissuance review and reevaluating that selection throughout the year as circumstances dictate. Criteria used for selecting engagements include the following:
  — Significant specialized industries with emphasis on high-risk engagements.
  — Audits of the financial statements of employee benefit plans.
  — First-year engagements.
  — Significant client engagements.
  — Level of service performed (that is, audit and attest, review, or compilation).
  — Engagements performed by all partners and other management-level personnel having accounting and auditing responsibilities.
  — Engagements performed under *Government Auditing Standards* (Yellow Book engagements).
  — Engagements for which there have been complaints or allegations from firm personnel, clients, or other third parties that the work performed by the firm failed to comply with professional standards, regulatory requirements, or the firm's system of quality control.
  — Engagements in which there were significant disagreements between the review partner and the engagement partner.
- Reviewing the selected engagements. Deficiencies identified as a result of this process are summarized and evaluated to determine whether the following are necessary:
  — Additional emphasis on specific areas or industries in future engagements.
  — Modifications to existing policies and procedures to prevent the deficiencies noted from recurring.
- Reviewing other engagement files at least annually for compliance with the firm's quality control policies and procedures including reviewing correspondence regarding consultation on independence, integrity, and objectivity matters (for example, assessments of significant clients) and acceptance and continuance decisions.
- Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.
- Preparing a summary of the deficiencies noted resulting from the preissuance and postissuance reviews so that the partner may incorporate any recommended changes into the firm's policies and procedures.
- Communicating to all professional personnel the deficiencies noted and related changes in quality control procedures.
- Following up on planned corrective actions to determine whether the actions were taken as planned and whether they achieved the intended objectives.

3.51 *Scenario 2: Monitoring by Inspecting a Sample of Engagements During a Designated Period of the Year.* Singleoffice CPA Firm implements Policy 2 through the following procedures:

- Designating a partner to be responsible for performing an annual inspection using guidance prepared by the AICPA for performing inspection procedures. These procedures include reviewing a cross-section of engagements using the following criteria in selecting engagements:
  - Significant specialized industries with emphasis on high-risk engagements.
  - Audits of the financial statements of employee benefit plans.
  - First-year engagements.
  - Significant client engagements.
  - Level of service performed (that is, audit and attest, review, or compilation).
  - Engagements performed by all partners and other management-level personnel having accounting and auditing responsibilities.
  - Engagements performed under *Government Auditing Standards* (Yellow Book engagements).
  - Engagements for which there have been complaints or allegations from firm personnel, clients, or other third parties that the work performed by the firm failed to comply with professional standards, regulatory requirements, or the firm's system of quality control.
  - Engagements in which there were significant disagreements between the quality review partner and the engagement partner.
- Establishing an approach and timetable for performing the inspection procedures and determining the forms and checklists to be used during the inspection and the extent of documentation required.
- Deciding how long to retain detailed inspection documentation (as opposed to summaries).
- Reviewing correspondence regarding consultation on independence, integrity, and objectivity matters and acceptance and continuance decisions.
- Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.
- Selecting a sample of engagements for review to determine compliance with the firm's quality control policies and procedures, reevaluating that selection throughout the process, and reviewing the selected engagements.
- Preparing a summary inspection report for the partner or management group that evaluates the overall results of the inspection and sets forth any recommended changes that should be made to the firm's policies and procedures.
- Reviewing the recommended corrective actions and reaching final conclusions about the actions to be taken.
- Communicating inspection findings and quality control changes to all professional personnel.
- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).

3.52 In addition to the procedures described under Scenarios 1 or 2, Singleoffice CPA Firm also implements Policy 2 through the following procedures:

- Reviewing and evaluating firm practice aids, such as audit programs, forms, and checklists, and considering whether they reflect recent professional pronouncements
- Providing information during staff meetings regarding new professional standards, regulatory requirements, and the related changes that should be made to firm practice aids
- Reviewing, or designating a management-level individual to be responsible for reviewing, the professional development policies and procedures to determine whether they are appropriate, effective, and meet the needs of the firm

- Reviewing, or designating a management-level individual to review summaries of the CPE records of the firm's professional personnel to evaluate each individual's compliance with the requirements of the AICPA and other applicable regulators
- Reviewing other administrative and personnel records pertaining to the quality control elements
- Soliciting information from the firm's personnel during staff meetings regarding the effectiveness of training programs

3.53 *Policy 3: The firm communicates (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its quality control system process to relevant firm personnel at least annually.* Singleoffice CPA Firm implements this policy through the following procedures:

- Preparing a summary report for the partners that evaluates the overall results of the monitoring and sets forth any recommended changes that should be made to the firm's policies and procedures
- Reviewing the recommended corrective actions and reaching final conclusions regarding the actions to be taken
- Communicating to all professional personnel the deficiencies noted and the related changes in quality control procedures
- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s)

3.54 *Policy 4: The firm deals appropriately with complaints and allegations.* Singleoffice CPA Firm implements this policy through the following procedures:

- Having the managing partner inform personnel that they may raise any concerns regarding complaints or allegations about noncompliance with professional standards, regulatory and legal requirements, or the firm's system of quality control with any partner without fear of reprisals.
- Having a partner who is not otherwise involved in the engagement investigate the following:
  - — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements.
  - — Allegations of noncompliance with the firm's system of quality control.
  - — Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.
- Documenting complaints and allegations and the responses to them.

3.55 *Policy 5: The firm prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.* Singleoffice CPA Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of quality control, including the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected
- A record of the evaluation of the following:
  - — Adherence to professional standards and regulatory and legal requirements
  - — Whether the quality control system has been appropriately designed and effectively implemented
  - — Whether the firm's quality control policies and procedures have been appropriately applied so that reports that are issued by the firm or engagement partners are appropriate in the circumstances

- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

3.56 *Policy 6: The firm retains documentation providing evidence of the operation of the system of quality control for an appropriate period of time*. Singleoffice CPA Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

Chapter 4: System of Quality Control for a CPA Firm's Accounting Practice—Sole Practitioner

4.01 This chapter describes how a sole practitioner (Sole Practitioner, CPA) implements each element of quality control in her accounting practice. Sole Practitioner, CPA, is a hypothetical firm of which Sole Practitioner, CPA, is the sole owner. The firm has no professional staff; however, on occasion Sole Practitioner, CPA, hires per diem professionals. Her accounting practice consists only of engagements subject to Statements on Standards for Accounting and Review Services (SSARSs). She uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. Sole Practitioner, CPA, uses per diem personnel to assist her and recognizes that her policies and procedures would have to change if she were to perform audit or attest engagements or hire full-time or part-time professional staff.

Quality Control Policies and Procedures

4.02 The firm's system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The policies and procedures are required to be documented. Sole Practitioner, CPA, documents her system of quality control by filling out checklists and questionnaires such as those included in the AICPA Peer Review Program Manual. Sole Practitioner, CPA, reviews the documentation at least annually and updates it as necessary.

4.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

4.04 Sole Practitioner, CPA, meets this requirement with regard to herself by annually reviewing the checklists and questionnaires used to document each element of her system of quality control. Sole Practitioner, CPA, communicates her policies and procedures to per diem professionals when they are initially contracted for an engagement by holding a discussion with them and follows up on individual engagements. Sole Practitioner, CPA, requires per diem personnel to be familiar with and to comply with these policies and procedures.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

4.05 The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Sole Practitioner, CPA, satisfies this purpose by establishing and maintaining the policies and procedures described in paragraphs 4.06–.08.

4.06 *Policy 1: I am ultimately responsible for the firm's system of quality control.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Accepting responsibility for the firm's system of quality control
- Educating herself about requirements for a system of quality control
- Designing and implementing policies and procedures required for her firm's system of quality control

4.07 *Policy 2: Commercial considerations do not override the quality of the work performed.* Sole Practitioner, CPA, implements this policy by continually evaluating client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control.

4.08 *Policy 3: I devote sufficient and appropriate resources for the development, communication, and support of the firm's quality control policies and procedures.* Sole Practitioner, CPA, implements this policy by reviewing and updating the quality control policies, procedures, and documentation on an annual basis.

Relevant Ethical Requirements

4.09 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Sole Practitioner, CPA, obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 4.10–.13.

4.10 *Policy 1: I adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Subscribing to the AICPA *Professional Standards* service.
- Consulting the AICPA website for information about changes in professional ethics and independence standards.
- Reviewing unpaid client fees to ascertain whether any outstanding amounts impair the firm's independence.
- Reviewing relevant pronouncements published in the *Journal of Accountancy* relating to independence, integrity, and objectivity and retaining relevant issues of the *Journal of Accountancy*.
- Attending periodic professional training in ethics and independence.
- Complying with SSARSs by disclosing in the accountant's compilation report instances in which the firm is not independent.
- Considering the significance of each client to the firm. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (*a*) the amount of time the partner devotes to the engagement and (*b*) the effect that losing the client would have on the firm.

4.11 *Policy 2: I communicate independence requirements to per diem professionals.* Sole Practitioner, CPA, implements this policy by making per diem personnel aware of financial, family, business, and other relationships that may be prohibited by applicable requirements.

4.12 *Policy 3: I establish procedures to identify and evaluate possible threats to independence and objectivity and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards. I withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Considering relevant information about client engagements, including the scope of services, to enable her to evaluate the overall impact on independence.
- Consulting with AICPA Ethics Hotline with concerns about possible threats to independence.
- Accumulating and communicating relevant information to per diem personnel as appropriate so that the following can occur:
    - — Sole Practitioner, CPA, and per diem personnel can readily determine whether they satisfy independence requirements.
    - — Sole Practitioner, CPA, can maintain and update information relating to independence.
    - — Sole Practitioner, CPA, can take appropriate action regarding identified threats to independence.

- Requiring per diem personnel to promptly notify her of independence breaches of which they become aware, and circumstances and relationships that create a threat to independence, so that appropriate action can be taken.
- Documenting any safeguards applied to eliminate threats to independence or reduce them to an acceptable level.
- Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.

4.13 *Policy 4: I confirm, in writing, my compliance with policies and procedures on independence and require written confirmation from all per diem professionals required to be independent by relevant requirements.* Sole Practitioner, CPA, implements this policy by signing a step on each engagement program attesting to her independence and requiring per diem personnel to do the same.

Acceptance and Continuance of Client Relationships and Specific Engagements

4.14 The purpose of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements;
- has considered the client's integrity and does not have information that would lead it to conclude that the client lacks integrity; and
- has reached an understanding with the client regarding the services to be performed.

4.15 Sole Practitioner, CPA, obtains this assurance, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the policies and procedures described in paragraphs 4.16–.20.

4.16 *Policy 1: I evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Obtaining information such as the following before accepting or continuing a client:
  - The nature and purpose of the services to be provided.
  - The identity of the client's principal owners, key management, related parties, and those charged with its governance.
  - The nature of the client's operations, including its business practices, from sources such as prior-year reports, internally generated financial statements (if applicable), income tax returns, and credit reports.
  - Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting.
- Inquiring of third parties such as bankers, factors, and legal counsel about management's business reputation and integrity.

- Communicating with the predecessor accountant when required or suggested by professional standards.[1]
- Evaluating the information obtained regarding management's integrity.
- Evaluating the risk of providing review services to significant clients or to other clients for which Sole Practitioner's, CPA, objectivity or the appearance of independence may be impaired. In determining the significance of a client, Sole Practitioner, CPA, considers the amount of time she devotes to the engagement and the effect that losing the client would have on her practice.

4.17 *Policy 2: I evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing a cut-off date by which evaluations of engagements should be performed, for example, before work on the current-year engagement begins.
- Considering conditions, such as the following, that require reevaluation of a client or specific engagement and obtaining the relevant information to determine whether the relationship should be continued:
  - Significant changes in the client, for example, a major change in ownership, senior client personnel, directors, advisers, the nature of the business, or the financial stability of the client.
  - Changes in the nature or scope of the engagement, including requests for additional services.
  - Client significance.
  - Matters that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance. If such matters exist, Sole Practitioner, CPA, considers the professional and legal responsibilities that apply to the circumstances and the possibility of withdrawing from the engagement or both the engagement and the client relationship.
  - The client's delinquency in paying fees. (This also may affect the firm's independence.)
- Determining if she has, or can reasonably obtain, the knowledge and expertise to perform the engagement.
- Evaluating the information obtained regarding the engagement, making the acceptance or continuance decision, and documenting her evaluation or conclusion in a memorandum or by signing off next to the relevant item in a practice aid.

4.18 *Policy 3: I obtain an understanding with the client regarding the services to be performed.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Adhering to all requirements set forth in professional standards regarding obtaining an understanding with the client
- Requiring that the understanding with the client be documented either through an engagement letter or in a memorandum

4.19 *Policy 4: I follow established procedures on withdrawal from an engagement or from both the engagement and the client relationship.* Sole Practitioner, CPA, implements this policy by discussing the issues and her

[1] AR section 400, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*), provides guidance on communications between a predecessor and successor accountant when the successor accountant decides to communicate with the predecessor accountant. It also requires a successor accountant who becomes aware of information that leads him or her to believe the financial statements reported on by the predecessor accountant may require revision to request that the client communicate this information to the predecessor accountant.

conclusion with the appropriate level of the client's management and those charged with its governance. If she considers it necessary, she also discusses her decision with her attorney.

4.20 *Policy 5: I document how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.* Sole Practitioner, CPA, implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

4.21 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Sole Practitioner, CPA, obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 4.22–.23.

4.22 *Policy 1: I hire per diem personnel of integrity who possess the characteristics that enable them to perform competently.* Sole Practitioner, CPA, implements this policy by setting criteria, regarding such factors as education, certification or licensure, and experience, which per diem personnel must meet to be hired.

4.23 *Policy 2: I maintain the knowledge, skills, and abilities required in the circumstances by participating in general and industry-specific continuing professional education (CPE) and professional development activities that enable me to accomplish my responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other applicable regulators. I also monitor the compliance of per diem employees with CPE requirements.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Maintaining the competencies necessary to accomplish responsibilities related to each of the firm's engagements
- Establishing a professional development program that takes into account the requirements of the AICPA and state boards of accountancy
- Participating in external professional development programs, including graduate-level and self-study courses
- Joining and becoming an active member of professional organizations
- Serving on professional committees, writing for professional publications on topics she is knowledgeable about, and participating in other professional activities
- Considering changes in the applicable professional standards when determining her professional development program
- Setting criteria that per diem personnel must meet to competently perform engagements, such as the following examples:
    - Determining that per diem personnel are in compliance with the applicable professional education requirements of the AICPA, state boards of accountancy, and state CPA societies
    - Obtaining and retaining documentation of such compliance
- Evaluating the knowledge and expertise required to perform an engagement prior to accepting the client or engagement
- Reading professional publications, such as state society journals, to keep abreast of changes in accounting standards and any industry-specific pronouncements that affect the client
- Consulting the AICPA website for information about changes in professional standards

Engagement Performance

4.24 The purpose of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the practitioner-in-charge issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Sole Practitioner, CPA, obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 4.25–.32.

4.25 *Policy 1: I plan engagements to meet professional standards, regulatory requirements, and the firm's requirements.* Sole Practitioner, CPA, implements this policy by adhering to professional standards regarding the planning process and the extent of documentation of the planning, if applicable. Engagement planning considerations may include the following:

- Developing or updating client information.
- Assessing the significance of the client to her firm.
- Obtaining an engagement letter for engagements performed under SSARSs. AR section 80, *Compilation of Financial Statements* (AICPA, *Professional Standards*), requires the accountant to either issue a compilation report or document an understanding with the entity through the use of an engagement letter when the accountant submits financial statements to a client that are not expected to be used by a third party.
- Reviewing prior financial statements and accountants' reports.
- Using work programs and applicable reporting and disclosure checklists.

4.26 *Policy 2: I perform, supervise, review, document, and report (or communicate) in accordance with the requirements of professional standards.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Requiring the use of appropriate practice aids in all engagements
- Maintaining the availability of current practice aids and AICPA professional standards
- Briefing per diem personnel on the engagement so that they understand the objectives of their work
- Documenting the work performed in accordance with professional standards and the firm's policy
- Supervising per diem personnel as appropriate based on the following:
    - Understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation
    - Understanding of professional standards and regulatory and legal requirements
    - Technical knowledge, including knowledge of relevant information technology
    - Knowledge of relevant industries in which the client operates
    - Ability to apply professional judgment
    - Understanding of the firm's quality control policies and procedures
    - Experience level
- Reviewing and initialing all engagement documentation prepared by per diem personnel

4.27 *Policy 3: I complete the assembly of final engagement files on a timely basis.* Sole Practitioner, CPA, implements this policy by completing the assembly of final engagement files on a timely basis in accordance with professional standards and applicable regulatory requirements, if any.

4.28 *Policy 4: I maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing and applying controls to do the following:
  - — Clearly determine when and by whom engagement documentation was prepared and reviewed.
  - — Protect the integrity of the information at all stages of the engagement.
  - — Prevent unauthorized changes to the engagement documentation.
  - — Allow access to the engagement documentation by per diem personnel and other authorized parties as necessary to properly discharge their responsibilities.
- Tracking the distribution of engagement documentation materials to the per diem personnel at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement.
- Restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.
- Using passwords or data encryption, or both, to restrict access to electronic engagement documentation to authorized users.
- Using appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
  - — Generate copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
  - — Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
  - — Enable the copies to be retrieved and printed as necessary.

4.29 *Policy 5: I retain engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Retaining engagement documentation for a period of time sufficient to meet the requirements of the state board of accountancy and applicable professional standards
- Enabling the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time
- Providing, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed
- Enabling authorized external parties to access and review specific engagement documentation for quality control or other purposes

4.30 *Policy 6: I require that consultation take place when appropriate; I make sufficient and appropriate resources available to enable appropriate consultation to take place; I provide to those consulted all the relevant facts known to me; I document the nature, scope, and conclusions of such consultations; and I implement conclusions resulting from such consultations.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Maintaining current technical references to assist in resolving practice problems.
- Referring to the AICPA's Technical Hotline or other qualified individuals if a practice problem arises for which the firm needs additional expertise.
- Requiring that documentation of consultation include the following:
  - — All relevant facts and circumstances about the issue on which consultation was sought.
  - — References to professional literature used in the analysis of the matter.
  - — The results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented. This documentation is retained with the engagement documentation.

4.31 *Policy 7: I deal with and resolve differences of opinion; I document and implement the conclusions reached; and I do not release the report until the matter is resolved.* Sole Practitioner, CPA, implements this policy by (*a*) evaluating issues of professional judgment when differences of opinion arise with per diem personnel, with those consulted, or with an external reviewer and (*b*) resolving the matter before releasing the report. If persons involved in the engagement continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and document that a disagreement continues to exist.

4.32 *Policy 8: I have criteria for determining whether an engagement quality control review should be performed; I evaluate all engagements against the criteria before I accept the engagement; I contract with a qualified external person to perform the engagement quality control review; and I do not release the report until the review is completed.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing the following criteria for determining whether an engagement quality control review should be performed:
  - — The engagement is subject to Statements on Auditing Standards or Statements on Standards for Attestation Engagements.
  - — An initial engagement for a client is in a specialized industry in which Sole Practitioner, CPA, has had no previous experience.
  - — An engagement quality control review is required by law or regulation.
- Evaluating all engagements against the criteria.
- Contracting with a qualified external person to perform the engagement quality control review.
- Not releasing the report until the review is completed.

Monitoring

4.33 The purpose of the monitoring element of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

4.34 Sole Practitioner, CPA, obtains this assurance by establishing and maintaining the policies and procedures described in paragraphs 4.35–.39.

4.35 *Policy 1: I perform monitoring procedures that are sufficiently comprehensive to enable me to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Performing a postissuance review of selected engagements at least annually[2]
- Summarizing the findings from the firm's monitoring procedures at least annually and considering the systemic causes of findings that indicate improvements are needed
- Determining any corrective actions or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures and taking those actions, including necessary modifications to the quality control system, on a timely basis
- Reviewing compliance with the firm's policies and procedures related to relevant ethical responsibilities, including independence, human resources, acceptance and continuance of client relationships and specific engagements, and engagement performance
- Reviewing all policies and procedures and revising those affected by changes in professional standards or the nature of her practice
- Reviewing and determining that the firm's practice aids are current and reflect recent professional pronouncements and changes in her practice
- Reviewing CPE records to determine whether the classroom training and self-study programs she uses are appropriate for the firm's practice
- Reviewing CPE records to determine compliance with the requirements of the AICPA and other applicable regulatory agencies

4.36 *Policy 2: I deal appropriately with complaints and allegations.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Investigating the following:
    - — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
    - — Allegations of noncompliance with the firm's system of quality control
    - — Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Documenting complaints and allegations and the responses to them

4.37 *Policy 3: I prepare appropriate documentation to provide evidence of the operation of each element of the firm's system of quality control.* Sole Practitioner, CPA, implements this policy by documenting evidence of the operation of each element of the firm's system of quality control by preparing a memorandum of the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be subject to postissuance review
- A record of the evaluation of the following:
    - — Adherence to professional standards and regulatory and legal requirements
    - — Whether the quality control system has been appropriately designed and effectively implemented

[2] A postissuance review may be performed as part of an inspection. A sole proprietor may consider engaging another CPA to perform the inspection to obtain a fresh look at the engagement. See paragraph 3.52 for a description of how a firm considers and evaluates, on an ongoing basis, compliance with a firm's policies and procedures by performing an annual inspection. Note that a preissuance review by the sole proprietor does not satisfy the monitoring requirements.

— Whether the firm's quality control policies and procedures have been appropriately applied so that reports that are issued by the firm are appropriate in the circumstances

- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

4.38 Although the form and content of that documentation is a matter of judgment, the illustration in table 1, "Summary of Quality Control Monitoring For the Calendar Year 20XX," in this chapter is an example of such documentation.

4.39 *Policy 4: I retain documentation of evidence of the operation of the system of quality control for an appropriate period of time.* Sole Practitioner, CPA, implements this policy by requiring retention of the summary report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

Table 1: Summary of Quality Control Monitoring For the Calendar Year 20XX

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Leadership Responsibilities for Quality Within the Firm		**These policies are evidenced by the overall operation of the firm's system of quality control.**
Relevant Ethical Requirements		
Policy 1. Adhering to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, and other applicable regulators.	JB 6/30/XX	Independence confirmation files
Policy 2. Communicating independence requirements to per diem professionals and, where applicable, others subject to them.	JB 6/30/XX	Independence confirmation files
Policy 3. Establishing procedures to help mitigate possible threats to my independence and objectivity.	JB 6/30/XX	Independence confirmation files
Policy 4. Confirming, in writing, my compliance with policies and procedures on independence and obtaining written confirmation from all per diem professionals required to be independent by relevant requirements.	JB 6/30/XX	Independence confirmation files
Acceptance and Continuance of Client Relationships and Specific Engagements		
Policy 1. Evaluating factors that have a bearing on management's integrity and considering the risk associated with providing professional services in particular circumstances.	JB 6/30/XX	Client acceptance files and client engagement files
Policy 2. Accepting or continuing to perform only those engagements that I can complete with professional competence and evaluating whether the relationship should be continued.	JB 6/30/XX	Engagement files

(continued)

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Policy 3. Obtaining an understanding with the client regarding services to be performed.	JB 6/30/XX	Engagement files
Policy 4. Following established procedures on withdrawal from an engagement or from both the engagement and the client relationship.	JB 6/30/XX	Not applicable for year ended 20XX
Policy 5. Documenting how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.	JB 6/30/XX	Client acceptance files and client engagement files
Human Resources		
Policy 1. Hiring per diem personnel of integrity who possess the characteristics that enable them to perform competently.	JB 6/30/XX	Personnel files
Policy 2. (*a*) Maintaining the knowledge, skills, and abilities required in the circumstances by participating in general and industry-specific continuing professional education (CPE) and professional development activities that enable me to accomplish my responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA society, state boards of accountancy, and other applicable regulators and (*b*) monitoring for compliance the CPE requirements of per diem employees.	JB 6/30/XX	Personnel files
Engagement Performance		
Policy 1. Planning engagements to meet professional standards, regulatory requirements, and the firm's requirements.	JB 6/30/XX	Engagement files
Policy 2. Performing, supervising, reviewing, documenting, and reporting (or communicating) in accordance with the requirements of professional standards.	JB 6/30/XX	Engagement files
Policy 3. Completing the assembly of final engagement files on a timely basis.	JB 6/30/XX	Engagement files
Policy 4. Maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.	JB 6/30/XX	Engagement files
Policy 5. Retaining engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.	JB 6/30/XX	Engagement files

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Policy 6. Requiring that consultation take place when appropriate; making sufficient and appropriate resources available to enable appropriate consultation to take place; providing to those consulted all the relevant facts known to me; documenting the nature, scope, and conclusions of such consultations; and implementing conclusions resulting from such consultations.	JB 6/30/XX	Engagement files
Policy 7. Dealing with and resolving differences of opinion; documenting and implementing the conclusions reached; and not releasing the report until the matter is resolved.	JB 6/30/XX	Engagement files
Policy 8. Evaluating all engagements against my criteria for an engagement quality control review; contracting with a qualified external person to perform the engagement quality control review; and not releasing the report until the review is completed.	JB 6/30/XX	Client acceptance files
Monitoring		
Policy 1. Performing monitoring procedures that are sufficiently comprehensive to enable me to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.	JB 6/30/XX	Monitoring files
Policy 2. Dealing appropriately with complaints and allegations.	JB 6/30/XX	Engagement files
Policy 3. Preparing appropriate documentation to provide evidence of the operation of each element of the firm's system of quality control.	JB 6/30/XX	Monitoring files
Policy 4. Retaining documentation of evidence of the operation of the system of quality control for an appropriate period of time.	JB 6/30/XX	Monitoring files

Chapter 5: System of Quality Control for an Alternative Practice Structure

5.01 An *alternative practice structure*, as referred to in this practice aid, is a nontraditional structure in the practice of public accounting that contains an attest and a nonattest portion. The attest portion is conducted through a firm owned and controlled by CPAs (a *closely aligned CPA firm*). The nonattest portion is conducted through a separate issuer or nonissuer firm owned and controlled by individuals who are not CPAs (a *non-CPA-owned entity*[1]). The non-CPA-owned entity may be an issuer or a nonissurer. Alternative practice structures are described in Interpretation 101-14, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .16), which is included as appendix B of this practice aid.

5.02 The quality control policies and procedures established by a closely aligned CPA firm that may or may not perform audit services are illustrated in chapters 2–3, as applicable. Additional quality control policies and procedures relevant to alternative practice structures may be necessary when certain portions of the CPA firm's system of quality control (*a*) reside at the non-CPA-owned entity or (*b*) operate in conjunction with the system of quality control of the non-CPA-owned entity.

5.03 Elements of quality control that might reside in a non-CPA-owned entity include the following:

- Relevant ethical requirements
- Human resources
- Monitoring of relevant ethical requirements and human resources

For example, the non-CPA-owned entity may be responsible for hiring personnel for both firms.

5.04 This chapter describes how Non-CPA-Owned Entity and Closely Aligned CPA Firm, hypothetical firms that are organized in an alternative practice structure, implement incremental quality control policies and procedures to address the previously mentioned elements of quality control that reside at Non-CPA-Owned Entity. Closely Aligned CPA Firm has no issuer clients[2] and implements the policies and procedures described in chapter 2, "System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Firm With Multiple Offices," of this practice aid.

Quality Control Policies and Procedures

5.05 *Policy 1: The top-tier company[3] maintains a system of quality control.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Designating a qualified individual to be responsible for the following:
  - Designing and directing the quality control activities at the top-tier company
  - Disseminating information to all subsidiaries and affiliated entities, all subsidiaries associated with CPA firms, and all CPA firms closely aligned with company subsidiaries
- Providing all company personnel and indirect superiors[4] with access to the company's quality control policies and procedures

[1] A *non-CPA-owned entity* is an entity that is closely aligned to a CPA firm through common employment; leasing of employees, equipment, or facilities; or other similar arrangements. In addition to one or more professional service subsidiaries or divisions that offer nonattest professional services (for example, tax, personal financial planning, and management consulting), a non-CPA-owned entity may have subsidiaries or divisions such as a bank, insurance company, or broker-dealer.

[2] If the closely aligned CPA firm were to be engaged to perform audit services for an issuer, the non-CPA-owned entity or its affiliated companies might need to revise their quality control policies and procedures to comply with Public Company Accounting Oversight Board standards and to reflect Securities and Exchange Commission requirements applicable to audits of issuers.

[3] The top-tier company is the parent company of the non-CPA-owned entity, which may be an issuer.

[4] Indirect superiors may be involved in regional management of direct superiors; thus, they may need to adhere to requirements.

Relevant Ethical Requirements

5.06 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Closely Aligned CPA Firm obtains this assurance by ensuring that Non-CPA-Owned Entity establishes and maintains the policies and procedures described in paragraphs 5.07–.09.

5.07 *Policy 1: Non-CPA-Owned Entity adheres to applicable relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes,the U.S. Government Accountability Office, and any other applicable regulators.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Developing policies and procedures to ensure the independence of Closely Aligned CPA Firm as required by the applicable aforementioned regulators. (Non-CPA-Owned Entity is required to be independent only in the context of its alignment with the CPA firm; it does not perform any attest functions, so its independence is not relevant.)
- Designating an officer to be responsible for providing guidance, answering questions, monitoring compliance, and resolving matters concerning independence, integrity, and objectivity of Closely Aligned CPA Firm.
- Determining when consultation with outside sources regarding independence, integrity, and objectivity matters is required.
- Reviewing written representations from *direct superiors* and *indirect superiors*[5] and others as applicable and resolving potential independence, integrity, and objectivity matters.
- Maintaining documentation of the resolution of independence, integrity, and objectivity matters.
- Requiring entity personnel to obtain sufficient training and education to accomplish their responsibilities with respect to independence, integrity, and objectivity.
- Obtaining from Closely Aligned CPA Firm a current list of all entities with which firm personnel are prohibited from having a financial or business relationship.[6]
- Obtaining written representations from personnel of Non-CPA-Owned Entity, upon hire and on an annual basis, stating that they are familiar with and in compliance with Non-CPA-Owned Entity's policies and procedures regarding independence, integrity, and objectivity.

5.08 *Policy 2: Personnel of Non-CPA-Owned Entity are familiar with policies and procedures regarding relevant ethical requirements.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Providing all of its personnel with access to its policies and procedures and guidance materials related to independence, integrity, and objectivity, such as manuals, memoranda, and databases containing professional and regulatory literature
- Advising personnel of Non-CPA-Owned Entity of the financial or other relationships, circumstances, or activities involving either individuals or entities that may be prohibited, as in the following examples:
  - — Business relationships with Closely Aligned CPA Firm's clients or with nonclients that have investor or investee relationships with Closely Aligned CPA Firm's clients

[5] *Direct superiors* are defined to include those persons so closely associated with a partner or manager who is a covered member that such persons can directly control the activities of such partner or manager. For this purpose, a person who can directly control is the immediate superior of the partner or manager who has the power to direct the activities of that person to be able to directly or indirectly (for example, through another entity over which the direct superior can exercise significant influence) derive a benefit from that person's activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. *Indirect superiors* are those persons who are one or more levels above direct superiors. Generally, this would start with persons in an organization structure to whom direct superiors report and go up the line from there.

[6] Examples of business relationships prohibited by independence standard-setting bodies such as the AICPA, the U.S. Government Accountability Office, and the U.S. Department of Labor because they might impair independence include being an investor in a joint venture with a client that is material or serving as a board member on the board of an audit client.

- — Loans to and from Closely Aligned CPA Firm's clients, including loans from Closely Aligned CPA Firm's financial institution clients
- — Family members who are employed by Closely Aligned CPA Firm's clients or who serve as director, officer, manager, or in other audit-sensitive positions with clients of Closely Aligned CPA Firm, including not-for-profit organizations
- — Past due fees from Closely Aligned CPA Firm's clients
- — Services in which the service provider assumes some of the responsibilities of client management
- — Performing certain bookkeeping services for governmental entities that are clients of Closely Aligned CPA Firm
- — Client relationships with Non-CPA-Owned Entity in which Closely Aligned CPA Firm leases employees, facilities, and so on
- — Situations in which personnel of Non-CPA-Owned Entity act as promoters, underwriters, voting trustees, directors, or officers of Closely Aligned CPA Firm's clients
- — Direct and material indirect financial interests in clients of Closely Aligned CPA Firm
- — Material investments by Closely Aligned CPA Firm's clients in Non-CPA-Owned Entity that allow the clients to exercise significant influence over Non-CPA-Owned Entity

- Advising personnel of Non-CPA-Owned Entity of the following:
  - — All direct superiors with whom, and all activities in which, Non-CPA-Owned Entity is prohibited from engaging, as defined in Non-CPA-Owned Entity's independence policies and procedures
  - — All indirect superiors with whom, and all activities in which, Non-CPA-Owned Entity is prohibited from engaging, as defined by Non-CPA-Owned Entity's policies and procedures
- Obtaining client lists from Closely Aligned CPA Firm to inform all personnel, on a timely basis, of Closely Aligned CPA Firm client's to which independence policies apply
- Obtaining documented representations from all Non-CPA-Owned Entity personnel (including those defined as direct and indirect superiors or supervisors of affiliated issuers),[7] upon hire and on an annual basis thereafter, stating that they are familiar with and in compliance with policies and procedures regarding relevant ethical requirements

5.09 *Policy 3: Non-CPA-Owned Entity identifies and evaluates possible threats to independence and objectivity and takes appropriate action to eliminate those threats or reduce them to an appropriate level by applying safeguards.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Assigning responsibility for obtaining, maintaining, and reviewing documented representations from all Non-CPA-Owned Entity personnel (see paragraph 5.08) for completeness and resolving reported exceptions with Non-CPA-Owned Entity's chief executive
- Requiring the chief executive of Non-CPA-Owned Entity to review or to designate an appropriate individual to review unpaid fees from clients of Closely Aligned CPA Firm to ascertain whether any outstanding amounts impair Closely Aligned CPA Firm's independence
- Requiring all professionals to report, on a timely basis when identified, circumstances and relationships that form a threat to independence so that appropriate action can be taken
- Requiring all professionals to report, on a timely basis when identified, apparent violations of independence, integrity, or objectivity policies involving themselves, their spouses, or their dependents and the corrective actions taken or proposed to be taken

[7] Affiliated issuers include the top-tier company and all entities consolidated in the top-tier company's financial statements. Individuals in these entities are not in situations in which a direct superior can exercise significant influence.

Human Resources

5.10 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Closely Aligned CPA Firm obtains this assurance by ensuring that Non-CPA-Owned Entity establishes and maintains the policies and procedures comparable to those that are described in paragraphs 5.11–.13 with regard to its leased or per diem personnel.

5.11 *Policy 1: Leased or per diem personnel possess characteristics that enable them to competently perform and review engagements.* Non-CPA-Owned Entity implements this policy by having knowledge and experience equivalent to that of Closely Aligned CPA Firm to make the following decisions:

- Designating an individual from Closely Aligned CPA Firm to be responsible for hiring and managing human resources within Non-CPA-Owned Entity on behalf of Closely Aligned CPA Firm.
- Reviewing Closely Aligned CPA Firm's personnel requirements for attest engagements to ensure that sufficient and capable staff persons are available to perform those engagements.
- Involving members of Closely Aligned CPA Firm in the process of hiring professionals on behalf of Closely Aligned CPA Firm that include establishing the attributes, achievements, and experiences desired in entry-level and experienced personnel. Such criteria assist in evaluating (*a*) the personal characteristics of professionals, such as integrity, competence, and motivation, and (*b*) whether professionals can competently perform responsibilities within Closely Aligned CPA Firm.
- Establishing guidelines for additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions.
- Establishing criteria for determining which individuals will be involved in interviewing and hiring personnel on behalf of Closely Aligned CPA Firm.

5.12 *Policy 2: Leased or per diem personnel participate in general and industry-specific continuing professional education (CPE) and other professional activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state accountancy boards, and other regulatory agencies.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Designating an individual to be responsible for CPE and professional development activities, including maintaining appropriate documentation evidencing that leased and per diem personnel have met the professional education requirements of the AICPA, state boards of accountancy, and other applicable regulators
- Establishing policies that require individuals performing audits, reviews, compilations, or attestation engagements for Closely Aligned CPA Firm to participate in CPE related to accounting and auditing
- Establishing policies requiring all leased or per diem personnel to be in compliance with the professional education requirements of the boards of accountancy in states where they are licensed and with the AICPA, state societies, and other regulatory agencies, as applicable
- Establishing an orientation and training policy for new hires who will perform audits, reviews, compilations, or attestation engagements for Closely Aligned CPA Firm or who will have partner- or manager-level responsibility for the overall supervision or review of such engagements
- Ensuring that leased or per diem personnel are informed about changes in accounting and auditing standards, independence, integrity, and objectivity requirements, and Closely Aligned CPA Firm's technical policies and procedures that are relevant to them
- Encouraging leased or per diem personnel to participate in other professional activities, such as graduate-level courses, membership in professional organizations, and serving on professional committees

5.13 *Policy 3: Leased or per diem personnel who are selected for advancement have the qualifications to accomplish the responsibilities they will be called upon to assume. Factors to consider include the degree of technical training and proficiency required in the circumstances and the nature and extent of supervision of assignments relating to audits, reviews, compilations, or attestation engagements performed by Closely Aligned CPA Firm.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Establishing a system for providing information to Closely Aligned CPA Firm so that it can make appropriate personnel decisions, such as assignments for audits, reviews, compilations, and attestation engagements.
- Designating an individual to be responsible for the following:
  - — Establishing criteria for the evaluation and advancement of leased or per diem personnel, including appropriate documentation.
  - — Making advancement and termination decisions, including identifying responsibilities and requirements for evaluation, at each professional level and deciding who will prepare those evaluations.
  - — Developing appropriate evaluation forms.
  - — Reviewing performance evaluations with personnel, discussing future objectives of Closely Aligned CPA Firm and the individual, and discussing assignment preferences.
  - — Periodically evaluating owners of Closely Aligned CPA Firm by means of peer evaluation or self-appraisal.
  - — Counseling leased or per diem personnel regarding their progress and career opportunities.
- Establishing an arrangement with Closely Aligned CPA Firm in which a supervisory-level individual of Closely Aligned CPA Firm is responsible for assisting Non-CPA-Owned Entity in making advancement and termination decisions concerning leased or per diem personnel. This would include evaluating personnel needs, establishing hiring objectives, and providing final approval.
- Developing a system for evaluating the performance of leased or per diem personnel and advising them of their progress.

Monitoring

5.14 The purpose of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the CPA firm are appropriate in the circumstances

5.15 A CPA firm that is closely aligned with a non-CPA-owned entity obtains this assurance by ensuring that the non-CPA-owned entity establishes and maintains the policies and procedures described in paragraphs 5.16–.19.

5.16 *Policy 1: Non-CPA-Owned Entity considers and evaluates, on an ongoing basis, the relevance and adequacy of its policies and procedures related to relevant ethical requirements that are applicable to all its personnel and its personnel management policies and procedures that are applicable to leased or per diem personnel.* Non-CPA-Owned Entity implements this policy by designating qualified individuals to be responsible for monitoring quality assurance, including ensuring that Non-CPA-Owned Entity's quality control guidance is regularly updated to reflect changes in professional standards related to independence, CPE, and other regulatory requirements through the following procedures:

- Implementing a system of ongoing monitoring of the effectiveness and appropriateness of policies and procedures related to independence, objectivity, and integrity as applicable to all personnel of Non-CPA-Owned Entity and compliance with those policies and procedures
- Ensuring, on an ongoing basis, that guidance materials and any practice aids Non-CPA-Owned Entity provides to Closely Aligned CPA Firm are appropriately designed to assist Closely Aligned CPA Firm in adhering to quality control standards
- Maintaining a system to ensure that the practice aids regarding independence and other technical matters provided by Non-CPA-Owned Entity are updated to reflect current professional standards and regulatory requirements and are relevant to and effective for Closely Aligned CPA Firm's practice
- Ensuring that Non-CPA-Owned Entity informs and provides guidance to leased or per diem personnel regarding new professional standards, regulatory requirements, and related changes to relevant Closely Aligned CPA Firm policies or practice aids

5.17 *Policy 2: Non-CPA-Owned Entity considers and evaluates, on an ongoing basis, compliance with its policies and procedures related to relevant ethical requirements that are applicable to all of its personnel and personnel management policies and procedures that are applicable to leased or per diem personnel.* Non-CPA-Owned Entity implements this policy by considering and evaluating, on an ongoing basis, compliance with policies and procedures related to independence, integrity, and objectivity, as applicable to all of its personnel, through the following procedures:

- Performing timely monitoring of policies and procedures, on an ongoing basis, related to independence, integrity, and objectivity to evaluate compliance with those policies and procedures. The monitoring policies and procedures could include an internal audit function, ongoing review by senior management, or engaging an independent CPA to examine and report on compliance.
- Summarizing and communicating the results of the monitoring to all of its personnel and communicating any suggested changes to policies and procedures to the appropriate levels of personnel in Non-CPA-Owned Entity.
- Correcting noted deficiencies based on the results of the monitoring to ensure compliance with policies and procedures.

5.18 *Policy 3: Non-CPA-Owned Entity deals appropriately with complaints and allegations.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Establishing procedures for concerns to be brought to the attention of the ethics committee in a confidential manner.
- Having the firm's ethics committee (excluding any members who are otherwise involved in the engagement under investigation) investigate the following:
  - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements.
  - Allegations of noncompliance with the firm's system of quality control.
  - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.
- Documenting complaints and allegations and the responses to them.

5.19 *Policy 4: Non-CPA-Owned Entity prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.* Non-CPA-Owned Entity implements this policy by preparing and retaining documentation that provides evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control.

Appendix A — Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control*

(Supersedes SQCS No. 7.)

Source: SQCS No. 8.

Effective date: Applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2012.

NOTE

In February 2014, the Auditing Standards Board issued SAS No. 128, *Using the Work of Internal Auditors* (AU-C sec. 610), which contains amendments to this section.

The amendments are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of December 15, 2014, and can be viewed in appendix B of AU-C section 610 until the effective date, when they will be applied to this section.

Introduction

Scope of This Section

.01 This section addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. This section is to be read in conjunction with the AICPA Code of Professional Conduct and other relevant ethical requirements.

.02 This section, although applicable to audit and attestation engagements performed by CPA firms in accordance with *Government Auditing Standards*, does not apply to government audit organizations. Instead, those government audit organizations are subject to the quality control and assurance requirements of *Government Auditing Standards*, which are similar to those of this section.

.03 Other professional standards set out additional requirements and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements. AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, for example, addresses quality control procedures for engagements conducted in accordance with generally accepted auditing standards. [Revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

.04 A system of quality control consists of policies designed to achieve the objective set out in paragraph .12 and the procedures necessary to implement and monitor compliance with those policies.

Authority of the SQCSs

.05 This section applies to all CPA firms with respect to engagements in their accounting and auditing practice. The nature and extent of the policies and procedures developed by an individual firm to comply with this section will depend on various factors, such as the size and operating characteristics of the firm and whether it is part of a network.

.06 Statements on Quality Control Standards (SQCSs) contain the objective of the firm in following the SQCSs and requirements designed to enable the firm to meet that stated objective. In addition, SQCSs contain related guidance in the form of application and other explanatory material, as discussed further in paragraph .09, and introductory material that provides context relevant to a proper understanding of the SQCSs and definitions.

.07 The objective provides the context in which the requirements of SQCSs are set and is intended to assist the firm in the following:

- Understanding what needs to be accomplished
- Deciding whether more needs to be done to achieve the objective

.08 SQCSs use two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on firms, as follows:

- *Unconditional requirements*. The firm is required to comply with an unconditional requirement in all cases in which such a requirement is relevant. SQCSs use the word *must* to indicate an unconditional requirement.
- *Presumptively mandatory requirements*. The firm is also required to comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant; however, in rare circumstances, the firm may depart from a presumptively mandatory requirement, provided that the firm documents the justification for the departure and how the alternative policies established, or procedures performed, in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. SQCSs use the word *should* to indicate a presumptively mandatory requirement.

If an SQCS provides that a procedure or action is one that the firm "should consider," the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not. The professional requirements of an SQCS are to be understood and applied in the context of the explanatory material that provides guidance for their application.

.09 When necessary, the application and other explanatory material provides further explanation of the requirements and guidance for carrying them out. In particular, it may

- explain more precisely what a requirement means or is intended to cover.
- include examples of policies and procedures that may be appropriate in the circumstances.

The words *may*, *might*, and *could*, among others, are used to describe these actions and procedures. Although such guidance does not, in itself, impose a requirement, it is relevant to the proper application of the requirements. The application and other explanatory material may also provide background information on matters addressed in SQCSs. When appropriate, additional considerations specific to governmental entities or smaller firms are included within the application and other explanatory material. These additional considerations assist in the application of the requirements in SQCSs. They do not, however, limit or reduce the responsibility of the firm to apply and comply with the requirements in SQCSs.

.10 SQCSs include, under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of the SQCSs. These are provided to assist in the consistent application and interpretation of SQCSs and are not intended to override definitions that may be established for other purposes, whether in law, regulation, or otherwise. The AU-C glossary contains a complete listing of terms defined in this section. It also includes descriptions of other terms found in this section to assist in common and consistent interpretation. [Revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

Effective Date

.11 The provisions of this section are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2012.

Objective

.12 The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that *a.* the firm and its personnel comply with professional standards and applicable legal and regulatory requirements and

b. reports issued by the firm are appropriate in the circumstances.

Definitions

.13 For purposes of SQCSs, the following terms have the meanings attributed as follows:

Accounting and auditing practice. A practice that performs engagements covered by this section, which are audit, attestation, compilation, review, and any other services for which standards have been promulgated by the AICPA Auditing Standards Board (ASB) or the AICPA Accounting and Review Services Committee (ARSC) under Rule 201, *General Standards* (ET sec. 201 par. .01), or Rule 202, *Compliance With Standards* (ET sec. 202 par. .01), of the AICPA Code of Professional Conduct. Although standards for other engagements may be promulgated by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an *accounting and auditing practice*.

Engagement documentation. The record of the work performed, results obtained, and conclusions that the practitioner reached (also known as *working papers* or *workpapers*).

Engagement partner. The partner or other person in the firm who is responsible for the engagement and its performance and for the report that is issued on behalf of the firm and who, when required, has the appropriate authority from a professional, legal, or regulatory body.

Engagement quality control review. A process designed to provide an objective evaluation, before the report is released, of the significant judgments the engagement team made and the conclusions it reached in formulating the report. The engagement quality control review process is only for those engagements, if any, for which the firm has determined that an engagement quality control review is required, in accordance with its policies and procedures.

Engagement quality control reviewer. A partner, other person in the firm, suitably qualified external person, or team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments that the engagement team made and the conclusions it reached in formulating the report.

Engagement team. All partners and staff performing the engagement and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes external specialists engaged by the firm or a network firm.[1]

Firm. A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the AICPA and that is engaged in the practice of public accounting.

Inspection. A retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them. Inspection includes a review of completed engagements.

Monitoring. A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including inspection or a periodic review of engagement documentation, reports, and clients' financial statements for a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is designed appropriately and operating effectively.

Network. An association of entities, as defined in ET section 92, *Definitions*.

Network firm. A firm or other entity that belongs to a network, as defined in ET section 92.

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[1] Paragraph .06 of AU-C section 620, *Using the Work of an Auditor's Specialist*, defines the term *auditor's specialist*. [Footnote revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

Partner. Any individual with authority to bind the firm with respect to the performance of a professional services engagement. For purposes of this definition, *partner* may include an employee with this authority who has not assumed the risks and benefits of ownership. Firms may use different titles to refer to individuals with this authority.

Personnel. Partners and staff.

Professional standards. Standards promulgated by the ASB or ARSC under Rules 201 or 202 of the AICPA Code of Professional Conduct, or other standards-setting bodies that set auditing and attest standards applicable to the engagement being performed and relevant ethical requirements.

Reasonable assurance. In the context of this section, a high, but not absolute, level of assurance.

Relevant ethical requirements. Ethical requirements to which the firm and its personnel are subject, which consist of the AICPA Code of Professional Conduct together with rules of applicable state boards of accountancy and applicable regulatory agencies that are more restrictive.

Staff. Professionals, other than partners, including any specialists that the firm employs.

Suitablyqualified external person. An individual outside the firm with the competence and capabilities to act as an engagement partner (for example, a partner of another firm).

[Revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

Requirements

Applying and Complying With Relevant Requirements

.14 Personnel within the firm responsible for establishing and maintaining the firm's system of quality control should have an understanding of the entire text of this section, including its application and other explanatory material, to understand its objective and apply its requirements properly.

.15 The firm should comply with each requirement of this section unless, in the circumstances of the firm, the requirement is not relevant to the services provided by a firm's accounting and auditing practice. (Ref: par. .A1)

.16 The requirements are designed to enable the firm to achieve the objective stated in this section. The proper application of the requirements is, therefore, expected to provide a sufficient basis for the achievement of the objective. However, because circumstances vary widely and all such circumstances cannot be anticipated, the firm should consider whether there are particular matters or circumstances that require the firm to establish policies and procedures in addition to those required by this section to meet the stated objective.

Elements of a System of Quality Control

.17 The firm must establish and maintain a system of quality control. The system of quality control should include policies and procedures addressing each of the following elements:

a. Leadership responsibilities for quality within the firm (the tone at the top)

b. Relevant ethical requirements

c. Acceptance and continuance of client relationships and specific engagements

d. Human resources

e. Engagement performance

f. Monitoring

Policies and procedures established by the firm related to each element are designed to achieve reasonable assurance with respect to the purpose of that element. Deficiencies in policies and procedures for an element may result in not achieving reasonable assurance with respect to the purpose of that element; however, the system of quality control as a whole may still be effective in achieving the objective described in paragraph .12.

.18 The firm should document its policies and procedures and communicate them to the firm's personnel. (Ref: par. .A2–.A3)

Leadership Responsibilities for Quality Within the Firm

.19 The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's leadership (managing partner or board of managing partners, CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control. (Ref: par. .A4–.A5)

.20 The firm should establish policies and procedures designed to provide it with reasonable assurance that any person or persons assigned operational responsibility for the firm's system of quality control by the firm's leadership has sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility. (Ref: par. .A6)

Relevant Ethical Requirements

.21 The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements. (Ref: par. .A7–.A9)

Independence

.22 The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm; its personnel; and, when applicable, others subject to independence requirements (including network firm personnel) maintain independence when required by relevant ethical requirements. Such policies and procedures should enable the firm to

a. communicate its independence requirements to its personnel and, when applicable, others subject to them and

b. identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards or, if considered appropriate, to withdraw from the engagement when withdrawal is possible under applicable law or regulation.

.23 Such policies and procedures should require

a. engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall effect, if any, on independence requirements;

b. personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and

c. the accumulation and communication of relevant information to appropriate personnel so that

   i. the firm and its personnel can readily determine whether they satisfy independence requirements,

   ii. the firm can maintain and update information relating to independence, and

iii. the firm can take appropriate action regarding identified threats to independence that are not at an acceptable level.

.24 The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for

a. personnel to promptly notify the firm of independence breaches of which they become aware;

b. the firm to promptly communicate identified breaches of these policies and procedures to

i. the engagement partner who, with the firm, needs to address the breach and

ii. other relevant personnel in the firm and, when appropriate, the network and those subject to the independence requirements who need to take appropriate action; and

c. prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter so that the firm can determine whether it should take further action.

.25 At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the requirements set forth in Rule 101, *Independence* (ET sec. 101 par. .01), and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. (Ref: par. .A10)

.26 The firm should establish policies and procedures for all audit or attestation engagements for which regulatory or other authorities require the rotation of personnel after a specified period, in compliance with such requirements.

Acceptance and Continuance of Client Relationships and Specific Engagements

.27 The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only when the firm

a. is competent to perform the engagement and has the capabilities, including time and resources, to do so; (Ref: par. .A11)

b. can comply with legal and relevant ethical requirements; and

c. has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity. (Ref: par. .A12–.A13)

.28 Such policies and procedures should

a. require the firm to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. (Ref: par. .A14)

b. require the firm to determine whether it is appropriate to accept the engagement if a potential conflict of interest is identified in accepting an engagement from a new or an existing client.

c. if issues have been identified and the firm decides to accept or continue the client relationship or a specific engagement, require the firm to

i. consider whether ethical requirements that exist under Interpretation No. 102-2, "Conflicts of Interest," under Rule 102, *Integrity and Objectivity* (ET sec. 102 par. .03), apply, such as disclosure of the relationship to the client and other appropriate parties, and

ii. document how the issues were resolved.

.29 To minimize the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed, the firm should establish policies and procedures that provide for obtaining an understanding with the client regarding those services. (Ref: par. .A15)

.30 The firm should establish policies and procedures on continuing an engagement and the client relationship that address the circumstances when the firm obtains information that would have caused it to decline the engagement had that information been available earlier. Such policies and procedures should include consideration of the following:

a. The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to regulatory authorities

b. The possibility of withdrawing from the engagement or from both the engagement and the client relationship (Ref: par. .A16)

Human Resources

.31 The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the competence, capabilities, and commitment to ethical principles necessary to

a. perform engagements in accordance with professional standards and applicable legal and regulatory requirements and

b. enable the firm to issue reports that are appropriate in the circumstances. (Ref: par. .A17–.A24)

.32 The firm's policies and procedures should provide that personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities that they will be called on to assume.

Assignment of Engagement Teams

.33 The firm should assign responsibility for each engagement to an engagement partner and should establish policies and procedures requiring that

a. the identity and role of the engagement partner are communicated to management and those charged with governance;

b. the engagement partner has the appropriate competence, capabilities, and authority to perform the role; and (Ref: par. .A25–.A30)

c. the responsibilities of the engagement partner are clearly defined and communicated to that individual.

.34 The firm should establish policies and procedures to assign appropriate personnel with the necessary competence and capabilities to

a. perform engagements in accordance with professional standards and applicable legal and regulatory requirements and

b. enable the firm to issue reports that are appropriate in the circumstances. (Ref: par. .A31)

Engagement Performance

.35 The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements and that the firm issues reports that are appropriate in the circumstances. Such policies and procedures should include the following:

a. Matters relevant to promoting consistency in the quality of engagement performance (Ref: par. .A32–.A33)

b. Supervision responsibilities (Ref: par. .A34)

c. Review responsibilities (Ref: par. .A35)

.36 The firm's review responsibility policies and procedures should be determined on the basis that suitably experienced engagement team members, which may include the engagement partner, review work performed by other engagement team members.

Consultation

.37 The firm should establish policies and procedures designed to provide it with reasonable assurance that

a. appropriate consultation takes place on difficult or contentious issues;

b. sufficient resources are available to enable appropriate consultation to take place;

c. the nature and scope of such consultations are documented and are agreed upon by both the individual seeking consultation and the individual consulted; and

d. the conclusions resulting from consultations are documented, understood by both the individual seeking consultation and the individual consulted, and implemented. (Ref: par. .A36–.A40)

Engagement Quality Control Review

.38 The firm should establish criteria against which all engagements covered by this section should be evaluated to determine whether an engagement quality control review should be performed. (Ref: par. .A41)

.39 The firm's policies and procedures should require that if an engagement meets the criteria established, an engagement quality control review should be performed for that engagement.

.40 The firm should establish policies and procedures setting out the nature, timing, and extent of an engagement quality control review. Such policies and procedures should require that the engagement quality control review be completed before the report is released. (Ref: par. .A42–.A44)

.41 The firm should establish policies and procedures to require the engagement quality control review to include *a.* discussion of significant findings and issues with the engagement partner;

b. reading the financial statements or other subject matter information and the proposed report;

c. review of selected engagement documentation relating to significant judgments that the engagement team made and the related conclusions it reached; and

d. evaluation of the conclusions reached in formulating the report and consideration of whether the proposed report is appropriate. (Ref: par. .A45–.A47)

Criteria for the Eligibility of Engagement Quality Control Reviewers

.42 The firm should establish policies and procedures to address the appointment of engagement quality control reviewers and to establish their eligibility through

a. the technical qualifications required to perform the role, including the necessary experience and authority, and (Ref: par. .A48)

b. the degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity. (Ref: par. .A49)

.43 The firm should establish policies and procedures designed to maintain the objectivity of the engagement quality control reviewer. Such policies and procedures should provide that although the engagement quality control reviewer is not a member of the engagement team, the engagement quality control reviewer should satisfy the independence requirements relating to the engagements reviewed. Accordingly, such policies and procedures should provide that the engagement quality control reviewer

a. when practicable, is not selected by the engagement partner.

b. does not otherwise participate in the performance of the engagement during the period of review.

c. does not make decisions for the engagement team.

d. is not subject to other considerations that would threaten the reviewer's objectivity.

.44 The firm's policies and procedures should provide for the replacement of the engagement quality control reviewer when the reviewer's ability to perform an objective review is likely to have been impaired. (Ref: par. .A50)

Documentation of the Engagement Quality Control Review

.45 The firm should establish policies and procedures on documentation of the engagement quality control review, which require documentation that

a. the procedures required by the firm's policies on engagement quality control review have been performed;

b. the engagement quality control review has been completed before the report is released; and

c. the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments that the engagement team made and the conclusions it reached were not appropriate.

Differences of Opinion

.46 The firm should establish policies and procedures for addressing and resolving differences of opinion within the engagement team; with those consulted; and, when applicable, between the engagement partner and the engagement quality control reviewer. (Ref: par. .A51–.A52)

.47 Such policies and procedures should enable a member of the engagement team to document that member's disagreement with the conclusions reached after appropriate consultation.

.48 Such policies and procedures should require the following:

a. Conclusions reached be documented and implemented

b. The report not be released until the matter is resolved

Engagement Documentation

Completion of the Assembly of Final Engagement Files

.49 The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been released. (Ref: par. .A53–.A54)

Confidentiality, Safe Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation

.50 The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation. (Ref: par. .A55–.A58)

Retention of Engagement Documentation

.51 The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm, professional standards, laws, and regulations. (Ref: par. .A59–.A62)

Monitoring

Monitoring the Firm's Quality Control Policies and Procedures

.52 The firm should establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. This process should

a. include an ongoing consideration and evaluation of the firm's system of quality control, including inspection or a periodic review of engagement documentation, reports, and clients' financial statements for a selection of completed engagements;

b. require responsibility for the monitoring process to be assigned to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility; and

c. assign the performance of monitoring the firm's system of quality control to qualified individuals. (Ref: par. .A63–.A73)

Evaluating, Communicating, and Remedying Identified Deficiencies

.53 Any system of quality control has inherent limitations that can reduce its effectiveness. Deficiencies in individual engagements covered by this section do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards.

.54 The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and determine whether they are either

a. instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and applicable legal and regulatory requirements and that the reports issued by the firm are appropriate in the circumstances or

b. systemic, repetitive, or other significant deficiencies that require prompt corrective action.

.55 The firm should communicate to relevant engagement partners, and other appropriate personnel, deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action. (Ref: par. .A74)

.56 Recommendations for appropriate remedial actions for deficiencies noted should include one or more of the following:

a. Taking appropriate remedial action in relation to an individual engagement or member of personnel

b. The communication of the findings to those responsible for training and professional development

c. Changes to the quality control policies and procedures

d. Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly

.57 The firm should establish policies and procedures to address cases when the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement. Such policies and procedures should require the firm to

a. determine what further action is appropriate to comply with relevant professional standards and legal and regulatory requirements and

b. consider whether to obtain legal advice.

.58 The firm should communicate, at least annually, the results of the monitoring of its system of quality control to engagement partners and other appropriate individuals within the firm, including the firm's leadership. This communication should be sufficient to enable the firm and these individuals to take prompt and appropriate action, when necessary, in accordance with their defined roles and responsibilities to provide a basis for them to rely on the firm's system of quality control. Information communicated should include the following:

a. A description of the monitoring procedures performed

b. The conclusions drawn from the monitoring procedures

c. When relevant, a description of systemic, repetitive, or other significant deficiencies and of the actions taken to resolve or amend those deficiencies

.59 Some firms operate as part of a network and, for consistency, may implement some of their monitoring procedures on a network basis. When firms within a network operate under common monitoring policies and procedures designed to comply with this section, and these firms place reliance on such a monitoring system, the firm's policies and procedures should require that

a. at least annually, the network communicate the overall scope, extent, and results of the monitoring process to appropriate individuals within the network firms and

b. the network communicate promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken in order that engagement partners in the network firms can rely on the results of the monitoring process implemented within the network, unless the firms or the network advise otherwise.

Complaints and Allegations

.60 The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with

a. complaints and allegations that the work performed by the firm fails to comply with professional standards and applicable legal and regulatory requirements and

b. allegations of noncompliance with the firm's system of quality control.

As part of this process, the firm should establish clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals. (Ref: par. .A75)

.61 If, during the investigations into complaints and allegations, deficiencies in the design or operation of the firm's quality control policies and procedures, or instances of noncompliance with the firm's system of quality control by an individual or individuals are identified, the firm should take appropriate actions, as set out in paragraph .56. (Ref: par. .A76–.A77)

Documentation of the System of Quality Control

.62 The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control. (Ref: par. .A78–.A80)

.63 The firm should establish policies and procedures that require retention of documentation for a period of time sufficient to permit those performing monitoring procedures and peer review of the firm to evaluate the firm's compliance with its system of quality control or for a longer period if required by law or regulation.[2]

.64 The firm should establish policies and procedures requiring documentation of complaints and allegations described in paragraph .60 and the responses to them.

Application and Other Explanatory Material

Applying and Complying With Relevant Requirements

Considerations Specific to Smaller Firms (Ref: par. .15)

.A1 This section does not call for compliance with requirements that are not relevant (for example, in the circumstances of a sole practitioner with no staff). Requirements in this section, such as those for policies and procedures for the assignment of appropriate personnel to the engagement team (see paragraph .34), for review responsibilities (see paragraph .36), and for the annual communication of the results of monitoring to engagement partners within the firm (see paragraph .58) are not relevant in the absence of staff.

Elements of a System of Quality Control (Ref: par. .18)

.A2 In general, communication of quality control policies and procedures to firm personnel includes a description of the quality control policies and procedures and the objectives they are designed to achieve and the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. By encouraging firm personnel to communicate their views or concerns on quality control matters, the firm recognizes the importance of obtaining feedback on the firm's system of quality control. Although communication is enhanced if it is in writing, the communication of quality control policies and procedures is not required to be in writing.

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[2] PR section 100, *Standards for Performing and Reporting on Peer Reviews*, is applicable to firms enrolled in the AICPA Peer Review Program.

Considerations Specific to Smaller Firms

.A3 Documentation and communication of policies and procedures for smaller firms may be less formal and extensive than for larger firms.

Leadership Responsibilities for Quality Within the Firm

Promoting an Internal Culture of Quality (Ref: par. .19)

.A4 The firm's leadership, and the examples it sets, significantly influences the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent, and frequent actions and messages from all levels of the firm's management that emphasize the firm's quality control policies and procedures and the requirement to

a. perform work that complies with professional standards and applicable legal and regulatory requirements.

b. issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards quality work. These actions and messages may be communicated by, but are not limited to, training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They may be incorporated in partner and staff appraisal procedures and the firm's internal documentation and training materials, such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

.A5 Of particular importance in promoting an internal culture based on quality is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs. Promoting such an internal culture includes the following:

a. Establishment of policies and procedures that address performance evaluation, compensation, and advancement (including incentive systems) with regard to its personnel in order to demonstrate the firm's overarching commitment to quality

b. Assignment of management responsibilities so that commercial considerations do not override the quality of the work performed

c. Provision of sufficient and appropriate resources for the development, documentation, and support of its quality control policies and procedures

Assigning Operational Responsibility for the Firm's System of Quality Control (Ref: par. .20)

.A6 Sufficient and appropriate experience and ability enables the person or persons responsible for the firm's system of quality control to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

Relevant Ethical Requirements

Compliance With Relevant Ethical Requirements (Ref: par. .21)

.A7 The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include the following:

- Responsibilities
- The public interest
- Integrity

- Objectivity and independence
- Due care
- Scope and nature of services

.A8 Independence requirements are set forth in Rule 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Guidance on threats to independence and safeguards to mitigate such threats involving matters that are not explicitly addressed in the Code of Professional Conduct are set forth in ET section 100-1, *Conceptual Framework for AICPA Independence Standards*.

.A9 The fundamental principles are reinforced, in particular, by the following:

- The leadership of the firm
- Education and training
- Monitoring
- A process for dealing with noncompliance

Written Confirmation (Ref: par. .25)

.A10 Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating noncompliance, the firm demonstrates the importance that it attaches to independence and keeps the issue current for, and visible to, its personnel.

Acceptance and Continuance of Client Relationships and Specific Engagements

Competence, Capabilities, and Resources (Ref: par. .27a)

.A11 Consideration of whether the firm has the competence, capabilities, and resources to undertake a new engagement from a new or an existing client involves reviewing the specific requirements of the engagement and the existing partner and staff profiles at all relevant levels, including whether

- firm personnel have knowledge of relevant industries or subject matters or the ability to effectively gain the necessary knowledge;
- firm personnel have experience with relevant regulatory or reporting requirements or the ability to effectively gain the necessary competencies;
- the firm has sufficient personnel with the necessary competence and capabilities;
- specialists are available, if needed;
- individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, when applicable; and
- the firm is able to complete the engagement within the reporting deadline.

Integrity of a Client (Ref: par. .27c)

.A12 Matters to consider regarding the integrity of a client include, for example, the following:

- The identity and business reputation of the client's principal owners, key management, and those charged with governance
- The nature of the client's operations, including its business practices
- Information concerning the attitude of the client's principal owners, key management, and those charged with governance toward such matters as internal control or aggressive interpretation of accounting standards

- Indications of an inappropriate limitation in the scope of the work
- Indications that the client might be involved in money laundering or other criminal activities
- The reasons for the proposed appointment of the firm and nonreappointment of the previous firm

The extent of knowledge that a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

.A13 Sources of information on such matters obtained by the firm may include the following:

- Communications with existing or previous providers of professional accountancy services to the client, in accordance with relevant ethical requirements, and discussions with other third parties
- Inquiry of other firm personnel or third parties, such as bankers, legal counsel, and industry peers
- Background searches of relevant databases

Continuance of a Client Relationship (Ref: par. .28a)

.A14 Deciding whether to continue a client relationship includes consideration of significant issues that have arisen during the current or previous engagements and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess, and cannot obtain, the necessary expertise.

Obtaining an Understanding With the Client (Ref: par. .29)

.A15 Professional standards applicable to the engagement may contain requirements for obtaining a written understanding with the client.

Withdrawal (Ref: par. .30)

.A16 Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship may address issues that include the following:

- Discussing with the appropriate level of the client's management and those charged with governance the appropriate action that the firm might take based on the relevant facts and circumstances
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with governance withdrawal from the engagement or from both the engagement and the client relationship and the reasons for the withdrawal
- Considering whether there is a professional, legal, or regulatory requirement for the firm to remain in place or for the firm to report the withdrawal from the engagement or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities
- Documenting significant matters, consultations, conclusions, and the basis for the conclusions

Human Resources (Ref: par. .31)

.A17 Personnel issues relevant to the firm's policies and procedures related to human resources include, for example, the following:

- Recruitment and hiring, if applicable
- Performance evaluation, compensation, and advancement
- Determining competencies and capabilities, including time to perform assignments
- Professional development
- The estimation of personnel needs

Effective recruitment processes and procedures help the firm select individuals of integrity who have the capacity to develop the competence and capabilities necessary to perform the firm's work and possess the appropriate characteristics to enable them to perform competently. Examples of such characteristics may include meeting minimum academic requirements established by the firm, maturity, integrity, and leadership traits.

.A18 *Competencies and capabilities* are the knowledge, skills, and abilities that qualify personnel to perform an engagement covered by this section. Competencies and capabilities are not measured by periods of time because such a quantitative measurement may not accurately reflect the kinds of experiences gained by personnel in any given time period. Accordingly, for purposes of this section, a measure of overall competency is qualitative rather than quantitative.

.A19 Competence can be developed through a variety of methods; these methods include, for example, the following:

- Professional education
- Continuing professional development, including training
- Work experience
- Mentoring by more experienced staff, such as other members of the engagement team
- Independence education for personnel who are required to be independent

.A20 The continuing competence of the firm's personnel depends, to a significant extent, on an appropriate level of continuing professional development so that personnel maintain their knowledge and capabilities. Effective policies and procedures emphasize the need for all levels of firm personnel to participate in general and industry-specific continuing professional education (CPE) and other professional development activities that enable them to fulfill responsibilities assigned and to satisfy applicable CPE requirements of the AICPA and regulatory agencies. Effective policies and procedures also place importance on passing the Uniform CPA Examination. The firm may provide the necessary training resources and assistance to enable personnel to develop and maintain the required competence and capabilities.

.A21 The firm may use a suitably qualified external person, for example, when internal technical and training resources are unavailable.

.A22 Effective performance evaluation, compensation, and advancement procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. Steps that a firm may take in developing and maintaining competence and commitment to ethical principles include the following:

- Making personnel aware of the firm's expectations regarding performance and ethical principles
- Providing personnel with an evaluation of, and counseling on, performance, progress, and career development
- Helping personnel understand that their compensation and advancement to positions of greater responsibility depend upon, among other things, performance quality and adherence to ethical principles and that failure to comply with the firm's policies and procedures may result in disciplinary action.

Considerations Specific to Smaller Firms

.A23 The size and circumstances of the firm are important considerations in determining the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

The Relationship of the Competency Requirement of the Uniform Accountancy Act to the Human Resource Element of Quality Control

.A24 CPAs are required to follow the accountancy laws of the individual licensing jurisdictions in the United States that govern the practice of public accounting. These jurisdictions may have adopted, in whole or in part, the Uniform Accountancy Act (UAA), which is a model legislative statute, including related administrative rules, designed by the AICPA and the National Association of State Boards of Accountancy to provide a uniform approach to the regulation of the accounting profession. The UAA provides that "[a]ny individual licensee ... who is responsible for supervising attest or compilation services and signs or authorizes someone to sign the accountant's report on the financial statements on behalf of the firm, shall meet the competency requirements set out in the professional standards for such services." A firm's compliance with this section is intended to enable a practitioner who performs accounting and auditing services on the firm's behalf to meet the competency requirement referred to in the UAA.

Assignment of Engagement Teams

Engagement Partners (Ref: par. .33)

.A25 In most cases, an engagement partner will have gained the necessary competencies through relevant and appropriate experience in engagements covered by this section. In some cases, however, an engagement partner may have obtained the necessary competencies through disciplines other than the practice of public accounting, such as in relevant industry, governmental, and academic positions. When necessary, the experience of the engagement partner may be supplemented by CPE and consultation. The following are examples:

- An engagement partner whose recent experience has consisted primarily in providing tax services may acquire the competencies necessary in the circumstances to perform a compilation or review engagement by obtaining relevant CPE.
- An engagement partner whose experience consists of performing review and compilation engagements may be able to obtain the necessary competencies to perform an audit by becoming familiar with the industry in which the client operates, obtaining CPE relating to auditing, using consulting sources during the course of performing the audit engagement, or any combination of these.
- A person in academia might obtain the necessary competencies to perform engagements covered by this section by (*a*) obtaining specialized knowledge through teaching or authorship of research projects or similar papers and (*b*) performing a rigorous self-study program or by engaging a consultant to assist on such engagements.

.A26 The characteristics of a particular client, industry, and the kind of service being provided determine the nature and extent of competencies established by a firm that are expected of the engagement partner. For example

- the competencies expected of an engagement partner to compile financial statements would be different than those expected of a practitioner engaged to review or audit financial statements.
- supervising engagements and signing or authorizing others to sign reports for clients in certain industries or engagements, such as financial services, governmental, or employee benefit plan engagements, would require different competencies than those expected in performing attest services for clients in other industries.
- the engagement partner for an attestation engagement to examine the effectiveness of an entity's internal control over financial reporting that is integrated with an audit of financial statements would be expected to have technical proficiency in understanding and evaluating the effectiveness of controls, whereas an engagement partner of an attestation engagement to examine investment performance statistics would be expected to have different competencies, including an understanding of the subject matter of the underlying assertion.

.A27 In practice, the competencies necessary for the engagement partner are broad and varied in both their nature and number. Competencies include the following, as well as other competencies as necessary in the circumstances:

- *Understanding of the role of a system of quality control and the Code of Professional Conduct*. An understanding of the role of a firm's system of quality control and the AICPA's Code of Professional Conduct, both of which play critical roles in assuring the integrity of the various kinds of reports.
- *Understanding of the service to be performed*. An understanding of the performance, supervision, and reporting aspects of the engagement. This understanding is usually gained through actual participation under appropriate supervision in that type of engagement.
- *Technical proficiency*. An understanding of the applicable professional standards, including those standards directly related to the industry in which a client operates, and the kinds of transactions in which a client engages.
- *Familiarity with the industry*. An understanding of the industry in which a client operates to the extent required by professional standards applicable to the kind of service being performed. In performing an audit or review of financial statements, this understanding would include an industry's organization and operating characteristics sufficient to identify areas of high or unusual risk associated with an engagement and to evaluate the reasonableness of industry-specific estimates.
- *Professional judgment*. Skills that indicate sound professional judgment. In performing engagements covered by this section, such skills would typically include the ability to exercise professional skepticism and identify areas requiring special consideration, including, for example, the evaluation of the reasonableness of estimates and representations made by management and the determination of the kind of report appropriate in the circumstances.
- *Understanding the organization's IT systems*. A sufficient understanding of how the organization is dependent on, or enabled by, information technologies and the manner in which the information systems are used to record and maintain financial information to determine when involvement of an IT professional is necessary for an audit engagement.

Interrelationship of Competencies and Other Elements of a Firm's System of Quality Control

.A28 The competencies previously listed are interrelated and gaining one particular competency may be related to achieving another. For example, familiarity with the client's industry interrelates with a practitioner's ability to make professional judgments relating to the client.

.A29 In establishing policies and procedures related to the nature of competencies needed by the engagement partner of an engagement, a firm may consider the requirements of policies and procedures established for other elements of quality control. For example, a firm might consider its requirements related to engagement performance in determining the nature of competency requirements that describe the degree of technical proficiency necessary in a given set of circumstances.

.A30 Policies and procedures may include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

Engagement Teams (Ref: par. .34)

.A31 The firm's assignment of engagement teams and the determination of the level of supervision required include, for example, consideration of the engagement team's

- understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation;
- understanding of professional standards and legal and regulatory requirements;
- technical knowledge and expertise, including knowledge of relevant IT;

- knowledge of relevant industries in which the clients operate;
- ability to apply professional judgment; and
- understanding of the firm's quality control policies and procedures.

Generally, as the ability and experience levels of assigned staff increase, the need for direct supervision decreases.

Engagement Performance

Consistency in the Quality of Engagement Performance (Ref: par. .35a)

.A32 The firm promotes consistency in the quality of engagement performance through its policies and procedures. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed may include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work
- Processes for complying with applicable engagement standards
- Processes of engagement supervision, staff training, and mentoring
- Methods of reviewing the work performed, the significant judgments made, and the type of report being issued
- Appropriate documentation of the work performed and of the timing and extent of the review
- Processes to keep all policies and procedures current

.A33 Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

Supervision (Ref: par. .35b)

.A34 Engagement supervision includes the following:

- Tracking the progress of the engagement
- Considering the competence and capabilities of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the engagement
- Addressing significant findings and issues arising during the engagement, considering their significance, and modifying the planned approach appropriately
- Identifying matters for consultation or consideration by more experienced engagement team members during the engagement

Review (Ref: par. .35c)

.A35 A review consists of consideration of whether

- the work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- significant findings and issues have been raised for further consideration;
- appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

- the nature, timing, and extent of the work performed is appropriate and without need for revision;
- the work performed supports the conclusions reached and is appropriately documented;
- the evidence obtained is sufficient and appropriate to support the report; and
- the objectives of the engagement procedures have been achieved.

Consultation (Ref: par. .37)

.A36 Consultation includes discussion at the appropriate professional level with individuals within or outside the firm who have relevant specialized expertise.

.A37 Consultation uses appropriate research resources, as well as the collective experience and technical expertise of the firm. Consultation helps promote quality and improves the application of professional judgment. Appropriate recognition of consultation in the firm's policies and procedures helps promote a culture in which consultation is recognized as a strength and personnel are encouraged to consult on difficult or contentious issues.

.A38 Effective consultation on significant technical, ethical, and other matters within the firm or, when applicable, outside the firm can be achieved when those consulted

- are given all the relevant facts that will enable them to provide informed advice and
- have appropriate knowledge, authority, and experience

and when conclusions resulting from consultations are appropriately documented and implemented.

.A39 Documentation that is sufficiently complete and detailed of consultations with other professionals that involve difficult or contentious matters contributes to an understanding of

- the issue on which consultation was sought and
- the results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented.

Considerations Specific to Smaller Firms

.A40 A firm needing to consult externally may take advantage of advisory services provided by the following:

- Other firms
- Professional and regulatory bodies
- Commercial organizations that provide relevant quality control services

Before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm determine whether the external provider is suitably qualified for that purpose.

Engagement Quality Control Review

Criteria for an Engagement Quality Control Review (Ref: par. .38)

.A41 The structure and nature of the firm's practice are important considerations in establishing criteria for determining which engagements are to be subject to an engagement quality control review. Such criteria may include, for example, the following:

- The nature of the engagement, including the extent to which it involves a matter of public interest
- The identification of unusual circumstances or risks in an engagement or class of engagements

- Whether laws or regulations require an engagement quality control review

Nature, Timing, and Extent of the Engagement Quality Control Review (Ref: par. .40–.41)

.A42 An engagement quality control review may include consideration of the following:

- The engagement team's evaluation of the firm's independence in relation to the specific engagement
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters and the conclusions arising from those consultations
- Whether documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached

.A43 If the engagement quality control review is completed after the report is dated and identifies instances where additional procedures are needed or additional evidence is required, the date of the report is changed to the date when the additional procedures have been satisfactorily completed or the additional evidence has been obtained, in accordance with the professional standards applicable to the engagement.

.A44 Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant issues to be promptly resolved to the engagement quality control reviewer's satisfaction before the report is released.

.A45 The extent of the engagement quality control review may depend upon, among other things, the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner.

.A46 Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review for audits, as well as reviews of financial statements and other assurance and related services engagements, include the following:

- Significant risks identified during the engagement and the responses to those risks
- Judgments made, particularly with respect to materiality and significant risks
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement
- The matters to be communicated to management and those charged with governance and, when applicable, other parties, such as regulatory bodies

.A47 When the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the firm's procedures for dealing with differences of opinion apply.

Criteria for the Eligibility of Engagement Quality Control Reviewers

Sufficient and Appropriate Technical Expertise, Experience, and Authority (Ref: par. .42*a*)

.A48 What constitutes sufficient and appropriate technical expertise, experience, and authority depends on the circumstances of the engagement.

Consultation With the Engagement Quality Control Reviewer (Ref: par. .42*b*)

.A49 The engagement partner may consult the engagement quality control reviewer at any stage during the engagement (for example, to establish that a judgment made by the engagement partner will be acceptable to the engagement quality control reviewer). Such consultation avoids identification of differences of opinion at a late stage of the engagement and does not necessarily impair the engagement quality control reviewer's eligibility to perform the role. When the nature and extent of the consultations become significant, the reviewer's objectivity may be impaired unless both the engagement team and the reviewer are careful to maintain the reviewer's objectivity. When this is not possible, another individual within the firm or a suitably qualified external person may be appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement.

Objectivity of the Engagement Quality Control Reviewer (Ref: par. .43–.44)

Considerations Specific to Smaller Firms

.A50 Suitably qualified external persons may be contracted when sole practitioners or small firms identify engagements requiring engagement quality control reviews and no person in the firm meets the eligibility requirements for an engagement quality control reviewer. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. When the firm contracts suitably qualified external persons or other firms, the requirements in paragraphs .43–.44 and the guidance in paragraph .A49 apply.

Differences of Opinion (Ref: par. .46)

.A51 Effective procedures encourage identification of differences of opinion at an early stage, provide clear guidelines about the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached.

.A52 Procedures to resolve such differences may include consulting with another practitioner or firm or a professional or regulatory body.

Engagement Documentation

Completion of the Assembly of Final Engagement Files (Ref: par. .49)

.A53 Professional standards, law, or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagements is to be completed. When no such time limits are prescribed, paragraph .49 requires the firm to establish time limits that reflect the need to complete the assembly of final engagement files on a timely basis.

.A54 When two or more different reports are issued regarding the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on financial information prepared in accordance with generally accepted accounting principles and, at a subsequent date, an auditor's report on the same financial information prepared in accordance with a special purpose framework for regulatory purposes.

Confidentiality, Safe Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation (Ref: par. .50)

.A55 Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information or a legal or professional duty exists to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly when data of a personal nature are concerned.

.A56 Whether engagement documentation is in paper, electronic, or other media, the integrity, accessibility, or retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the firm's knowledge or if it could be permanently lost or damaged. Accordingly, controls that the firm designs and implements to avoid unauthorized alteration or loss of engagement documentation may include those that

- enable the determination of when and by whom engagement documentation was prepared or reviewed;

- protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means;
- prevent unauthorized changes to the engagement documentation; and
- allow access to the engagement documentation by the engagement team and other authorized parties, as necessary, to properly discharge their responsibilities.

.A57 Controls that the firm designs and implements to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation may include the following:

- The use of a password by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement
- Procedures for properly distributing engagement documentation to the team members at the start of the engagement, processing it during the engagement, and collating it at the end of the engagement
- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hard copy engagement documentation

.A58 For practical reasons, original paper documentation may be electronically scanned or otherwise copied to another media for inclusion in engagement files. In such cases, the firm's procedures designed to maintain the integrity, accessibility, and retrievability of the documentation may include requiring the engagement teams to

- generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
- integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary.
- enable the scanned copies to be retrieved and printed as necessary.

There may be legal, regulatory, or other reasons for a firm to retain original paper documentation.

Retention of Engagement Documentation (Ref: par. .51)

.A59 The needs of the firm for retention of engagement documentation and the period of such retention will vary with the nature of the engagement and the firm's circumstances (for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements). The retention period may also depend on other factors, such as whether professional standards, law, or regulation prescribe specific retention periods for certain types of engagements or whether generally accepted retention periods exist in the absence of specific legal or regulatory requirements.

.A60 In the specific case of audit engagements, the retention period would be no shorter than five years from the report release date.[3]

.A61 Procedures that the firm may adopt for retention of engagement documentation include those that enable the requirements of paragraph .51 to be met during the retention period, such as, for example, procedures to

- enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time.

[3] Paragraph .17 of AU-C section 230, *Audit Documentation*. [Footnote revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

- provide, when necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed.
- enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Ownership of Engagement Documentation

.A62 Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided that such disclosure does not undermine the validity of the work performed or, in the case of assurance engagements, the independence of the firm or its personnel.

Monitoring

Monitoring the Firm's Quality Control Policies and Procedures (Ref: par. .52)

.A63 The purpose of monitoring compliance with quality control policies and procedures is to assess, for the system of quality control as a whole, whether the firm is achieving the objective described in paragraph .12 through an evaluation of the following:

- Adherence to professional standards and applicable legal and regulatory requirements
- Whether the system of quality control has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

The evaluation may identify circumstances that necessitate changes to, or improve compliance with, the firm's policies and procedures to provide the firm with reasonable assurance that its system of quality control is effective.

.A64 Ongoing consideration and evaluation of the system of quality control may include matters such as the following:

- Review of selected administrative and personnel records pertaining to the quality control elements
- Review of engagement documentation, reports, and clients' financial statements
- Discussions with the firm's personnel
- Determination of corrective actions to be taken and improvements to be made in the system, including providing feedback into the firm's policies and procedures relating to education and training
- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with the system
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures

.A65 Monitoring procedures also may include an assessment of the following:

- The appropriateness of the firm's guidance materials and any practice aids
- New developments in professional standards and legal and regulatory requirements and how they are reflected in the firm's policies and procedures, when appropriate
- Written confirmation of compliance with policies and procedures on independence
- The effectiveness of continuing professional development, including training
- Decisions related to acceptance and continuance of client relationships and specific engagements

- Firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof

.A66 Some of the monitoring procedures discussed previously may be accomplished through the performance of the following:

- Engagement quality control review
- Review of engagement documentation, reports, and clients' financial statements for selected engagements after the report release date
- Inspection procedures

Reviews of the work or report when performed by engagement team members prior to the date of the report are not monitoring procedures.

.A67 The need for, and extent of, inspection procedures depends, in part, on the existence and effectiveness of the other monitoring procedures. The nature of inspection procedures varies based on the firm's quality control policies and procedures and the effectiveness and results of other monitoring procedures.

.A68 The inspection of a selection of completed engagements may be performed on a cyclical basis. For example, engagements selected for inspection may include at least one engagement for each engagement partner over an inspection cycle that spans three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, such as the following:

- The size of the firm
- The number and geographical location of offices
- The results of previous monitoring procedures
- The degree of authority of both personnel and office (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them)
- The nature and complexity of the firm's practice and organization
- The risks associated with the firm's clients and specific engagements

.A69 Inspection procedures with respect to the engagement performance element of a quality control system are particularly appropriate in a firm with more than a limited number of management-level individuals responsible for the conduct of its accounting and auditing practice.

.A70 The inspection process involves the selection of individual engagements, some of which may be selected without prior notification to the engagement team. In determining the scope of the inspections, the firm may take into account the scope or conclusions of a peer review or regulatory inspections.

The Relationship of Peer Review to Monitoring

.A71 A peer review does not substitute for all monitoring procedures. However, because the objective of a peer review is similar to that of inspection procedures, a firm's quality control policies and procedures may provide that a peer review conducted under standards established by the AICPA may substitute for the inspection of engagement documentation, reports, and clients' financial statements for some or all engagements for the period covered by the peer review.

Considerations Specific to Smaller Firms

.A72 In small firms with a limited number of persons with sufficient and appropriate experience and authority in the firm, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. This includes review of engagement working papers, reports, and clients' financial statements by the engagement partner or other qualified personnel after the report release date. To effectively monitor one's own compliance with the firm's policies and procedures, it is necessary that an individual be able to critically review his or her own performance, assess his or her own strengths and weaknesses, and maintain an attitude of continual improvement. Changes in conditions and the environment within the firm (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm) may indicate the need to have quality control policies and procedures monitored by another qualified individual.

.A73 Having an individual inspect his or her own compliance with a quality control system may be less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm has a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm with a limited number of persons with sufficient and appropriate experience and authority in the firm may find it beneficial to engage a suitably qualified external person or another firm to perform engagement inspections and other monitoring procedures.

Communicating Deficiencies (Ref: par. .55)

.A74 The reporting of identified deficiencies to individuals other than the relevant engagement partners need not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

Complaints and Allegations

Source of Complaints and Allegations (Ref: par. .60)

.A75 Complaints and allegations of noncompliance with the firm's system of quality control (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients, state boards of accountancy, other regulators, or other third parties. They may be received by engagement team members or other firm personnel.

Investigation Policies and Procedures (Ref: par. .61)

.A76 Policies and procedures established for the investigation of complaints and allegations may include, for example, that the partner supervising the investigation

- has sufficient and appropriate experience,
- has authority within the firm, and
- is otherwise not involved in the engagement.

The partner supervising the investigation may involve legal counsel as necessary.

Considerations Specific to Smaller Firms

.A77 In the case of firms with few partners, it may not be practicable for the partner supervising the investigation not to be involved in the engagement. These small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation into complaints and allegations.

Documentation of the System of Quality Control (Ref: par. .62)

.A78 The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following:

- The size of the firm and the number of offices
- The nature and complexity of the firm's practice and organization

For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations, and the results of monitoring inspections.

.A79 Appropriate documentation relating to monitoring includes, for example, the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected
- A record of the evaluation of the following:
  - — Adherence to professional standards and applicable legal and regulatory requirements
  - — Whether the system of quality control has been appropriately designed and effectively implemented
  - — Whether the firm's quality control policies and procedures have been appropriately applied so that the reports that are issued by the firm are appropriate in the circumstances
- Identification of the deficiencies noted, an evaluation of their effect, and the basis for determining whether and what further action is necessary

Considerations Specific to Smaller Firms

.A80 Smaller firms may use more informal methods in the documentation of their systems of quality control, such as manual notes, checklists, and forms.

.A81

Exhibit — Comparison of Section 10, *A Firm's System of Quality Control*, and International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

> This analysis was prepared by the AICPA Audit and Attest Standards staff to highlight substantive differences between section 10, *A Firm's System of Quality Control*, and International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and the rationale therefore. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board (ASB).

Differences in Language

The ASB has made various changes to the language throughout section 10, as compared with ISQC 1. Such changes have been made to use terms applicable in the United States and to make section 10 easier to read and apply. The ASB believes that such changes will not create differences between the application of ISQC 1 and the application of section 10.

Requirements in Section 10 Not in ISQC 1

Section 10 requires firms to establish policies and procedures providing

- in paragraph .30, for obtaining an understanding with the client regarding the nature, scope, and limitations of the services to be performed.
- in paragraph .33, that personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.
- in paragraph .44, that although the engagement quality control reviewer is not a member of the engagement team, the engagement quality control reviewer should satisfy the independence requirements relating to the engagements reviewed.
- in paragraph .48, that when differences of opinion exist, a member of the engagement team be able to document that member's disagreement with the conclusions reached, after appropriate consultation.

ISQC 1 does not have equivalent requirements.

Requirements in ISQC 1 Not in Section 10

Paragraph 25 of ISQC 1 requires the firm to establish policies and procedures setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time. The ASB believes that the familiarity threat should not be singled out among other threats to independence.

Paragraph 48(a) of ISQC 1 requires including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner as a monitoring procedure. The ASB believes that this requirement is overly prescriptive and that a risk-based approach to inspections is more appropriate.

Requirements in ISQC 1 Revised in Section 10

Paragraph .41 of section 10 requires that when an engagement quality control review is performed, the engagement quality control review be completed before the report is released. Paragraph 36 of ISQC 1 requires that the quality control review be completed before the report is dated. The ASB believes that an engagement quality control review is an independent review of the engagement team's significant judgments, including the date selected by the engagement team to date the report. As noted in the application material to section 10, when the engagement quality control review results in additional procedures having to be performed, the date of the report would be changed.

Paragraph 48(c) of ISQC 1 requires that those performing the engagement or the engagement quality control review are not involved in inspecting the engagements. Paragraph .53*c* of section 10, consistent with the requirement in paragraph 100 of Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control*, requires that performance of monitoring of the firm's system of quality control be assigned to qualified individuals. Paragraph .A72 of section 10 notes that in small firms with a limited number of persons with sufficient and appropriate experience and authority in the firm, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. The ASB concluded that it was not necessary to change existing practice because in the United States, the peer review process provides a safeguard and provides evidence that the monitoring procedures are effective.

Paragraph A49 of ISQC 1 references the requirement in paragraph 40 of ISQC 1 to establish policies and procedures to maintain the objectivity of the engagement quality control reviewer and states, "Accordingly, such policies and procedures provide ...." The ASB believes that notwithstanding its placement as application material, the language is indicative of a requirement and, accordingly, has included a requirement for the provision of these specific policies and procedures in paragraph .44 of section 10. The ASB believes this will not create a difference in the application of ISQC 1 and the application of section 10.

[Revised, October 2011, to reflect conforming changes necessary due to the issuance of SAS No. 122.]

Appendix B — Interpretation No. 101-14, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules," of Rule 101

Because of changes in the manner in which **members**[*] are structuring their practices, the AICPA's Professional Ethics Executive Committee (PEEC) studied various alternatives to "traditional structures" to determine whether additional independence requirements are necessary to ensure the protection of the public interest.

In many "nontraditional structures," a substantial (the nonattest) portion of a member's practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm owned and controlled (as defined in FASB ASC 810) by the member. All such structures must comply with applicable laws, regulations, and Rule 505, *Form of Organization and Name* [sec. 505 par. .01]. In complying with laws, regulations, and Rule 505 [sec. 505 par. .01], many elements of quality control are required to ensure that the public interest is adequately protected. For example, all services performed by members and persons over whom they have control must comply with standards promulgated by AICPA Council-designated bodies, and, for all other firms providing attest services, enrollment is required in an AICPA-approved practice-monitoring program. Finally, and importantly, the members are responsible, financially and otherwise, for all the attest work performed. Considering the extent of such measures, PEEC believes that the additional independence rules set forth in this interpretation are sufficient to ensure that attest services can be performed with objectivity and, therefore, the additional rules satisfactorily protect the public interest.

Rule 505 [sec. 505 par. .01] and the following independence rules for an alternative practice structure (APS) are intended to be conceptual and applicable to all structures where the "traditional firm" engaged in attest services is closely aligned with another organization, public or private, that performs other professional services. The following paragraph and subsequent chart provide an example of a structure in use at the time this interpretation was developed. Many of the references in this interpretation are to the example. PEEC intends that the concepts expressed herein be applied, in spirit and in substance, to variations of the example structure as they develop.

The example APS in this interpretation is one where an existing CPA practice ("Oldfirm") is sold by its owners to another (possibly public) entity ("PublicCo"). PublicCo has subsidiaries or divisions such as a bank, insurance company, or broker-dealer, and it also has one or more professional service subsidiaries or divisions that offer to clients nonattest professional services (for example, tax, personal financial planning, and management consulting). The owners and employees of Oldfirm become employees of one of PublicCo's subsidiaries or divisions and may provide those nonattest services. In addition, the owners of Oldfirm form a new CPA firm ("Newfirm") to provide attest services. CPAs, including the former owners of Oldfirm, own a majority of Newfirm (as to vote and financial interests). Attest services are performed by Newfirm and are supervised by its owners. The arrangement between Newfirm and PublicCo (or one of its subsidiaries or divisions) includes the lease of employees, office space, and equipment; the performance of back-office functions such as billing and collections; and advertising. Newfirm pays a negotiated amount for these services.

APS Independence Rules for Covered Members

The term **covered member** in an APS includes both employed and leased individuals. The **firm** in such definition would be Newfirm in the example APS. All covered members, including the firm, are subject to Rule 101 [sec. 101 par. .01] and its interpretations and rulings in their entirety. For example, no covered member may have, among other things, a direct financial interest in or a loan to or from an attest client of Newfirm.

Partners of one Newfirm generally would not be considered partners of another Newfirm except in situations where those partners perform services for the other Newfirm or where there are significant shared economic interests between partners of more than one Newfirm. If, for example, partners of Newfirm 1 perform services in Newfirm 2, such owners would be considered to be partners of both Newfirms for purposes of applying the independence rules.

[*] Terms shown in **boldface** type upon first usage in this interpretation are defined in ET section 92, *Definitions* (AICPA, *Professional Standards*).

APS Independence Rules for Persons and Entities Other Than Covered Members

As stated previously, the independence rules normally extend only to those persons and entities included in the definition of covered member. This normally would include only the "traditional firm" (Newfirm in the example APS), those covered members who own or are employed or leased by Newfirm, and entities controlled (as defined by FASB ASC 810) by one or more of such persons. Because of the close alignment in many APSs between persons and entities included in covered member and other persons and entities, to ensure the protection of the public interest, PEEC believes it appropriate to require restrictions in addition to those required in a traditional firm structure. Those restrictions are divided into two groups:

1. *Direct Superiors.* Direct Superiors are defined to include those persons so closely associated with a partner or manager who is a covered member, that such persons can *directly control* the activities of such partner or manager. For this purpose, a person who can *directly control* is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (for example, through another entity over which the Direct Superior can exercise significant influence[1]) derive a benefit from that person's activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. This group of persons is, in the view of PEEC, so closely aligned through direct reporting relationships with such persons that their interests would seem to be inseparable. *Consequently, persons considered Direct Superiors, and entities within the APS over which such persons can exercise significant influence*[2] *are subject to Rule 101 [sec. 101 par. .01*] and its interpretations and rulings in their entirety.

2. *Indirect Superiors and Other PublicCo Entities.* Indirect Superiors are those persons who are one or more levels above persons included in Direct Superior. Generally, this would start with persons in an organization structure to whom Direct Superiors report and go up the line from there. PEEC believes that certain restrictions must be placed on Indirect Superiors, but also believes that such persons are sufficiently removed from partners and managers who are covered persons to permit a somewhat less restrictive standard. Indirect Superiors are not connected with partners and managers who are covered members through direct reporting relationships; there always is a level in between. The PEEC also believes that, for purposes of the following, the definition of Indirect Superior also includes the **immediate family** of the Indirect Superior.

PEEC carefully considered the risk that an Indirect Superior, through a Direct Superior, might attempt to influence the decisions made during the engagement for a Newfirm attest client. PEEC believes that this risk is reduced to a sufficiently low level by prohibiting certain relationships between Indirect Superiors and Newfirm attest clients and by applying a materiality concept with respect to financial relationships. If the financial relationship is not material to the Indirect Superior, PEEC believes that he or she would not be sufficiently financially motivated to attempt such influence particularly with sufficient effort to overcome the presumed integrity, objectivity and strength of character of individuals involved in the engagement.

Similar standards also are appropriate for Other PublicCo Entities. These entities are defined to include PublicCo and all entities consolidated in the PublicCo financial statements that are not subject to Rule 101 [sec. 101 par. .01] and its interpretations and rulings in their entirety.

The rules for Indirect Superiors and Other PublicCo Entities are as follows:

a. Indirect Superiors and Other PublicCo Entities may not have a relationship contemplated by item (A) of Interpretation 101-1 [sec. 101 par. .02] (for example, investments, loans, and so on) with an attest

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[1] For purposes of this interpretation, *significant influence* means having the ability to exercise significant influence over the financial, operating, or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner, or director, (2) being in a policy-making position such as CEO, chief operating officer, CFO, or chief accounting officer, or (3) meeting the criteria in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 323-10-15 to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

[2] For purposes of this interpretation, significant influence means having the ability to exercise significant influence over the financial, operating, or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner, or director, (2) being in a policy-making position such as CEO, chief operating officer, CFO, or chief accounting officer, or (3) meeting the criteria in FASB ASC 323-10-15 to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

client of Newfirm that is material. In making the test for materiality for financial relationships of an Indirect Superior, all the financial relationships with an attest client held by such person should be aggregated and, to determine materiality, assessed in relation to the person's net worth. In making the materiality test for financial relationships of Other PublicCo Entities, all the financial relationships with an attest client held by such entities should be aggregated and, to determine materiality, assessed in relation to the consolidated financial statements of PublicCo. In addition, any Other PublicCo Entity over which an Indirect Superior has direct responsibility cannot have a financial relationship with an attest client that is material in relation to the Other PublicCo Entity's financial statements.

b. Further, financial relationships of Indirect Superiors or Other PublicCo Entities should not allow such persons or entities to exercise significant influence[3] over the attest client. In making the test for significant influence, financial relationships of all Indirect Superiors and Other PublicCo Entities should be aggregated.

c. Neither Other PublicCo Entities nor any of their employees may be connected with an attest client of Newfirm as a promoter, underwriter, voting trustee, director or officer.

d. Except as noted in (*c*), Indirect Superiors and Other PublicCo Entities may provide services to an attest client of Newfirm that would impair independence if performed by Newfirm. For example, trustee and asset custodial services in the ordinary course of business by a bank subsidiary of PublicCo would be acceptable as long as the bank was not subject to Rule 101 [sec. 101 par. .01] and its interpretations and rulings in their entirety.

Other Matters

1. An example, using the following chart, of the application of the concept of Direct and Indirect Superiors would be as follows: The chief executive of the local office of the Professional Services Subsidiary (PSS), where the partners of Newfirm are employed, would be a Direct Superior. The chief executive of PSS itself would be an Indirect Superior, and there may be Indirect Superiors in between such as a regional chief executive of all PSS offices within a geographic area.

2. PEEC has concluded that Newfirm (and its partners and employees) may not perform an **attest engagement** for PublicCo or any of its subsidiaries or divisions.

3. PEEC has concluded that independence would be considered to be impaired with respect to an attest client of Newfirm if such attest client holds an investment in PublicCo that is material to the attest client or allows the attest client to exercise significant influence[4] over PublicCo.

4. When making referrals of services between Newfirm and any of the entities within PublicCo, a member should consider the provisions of Interpretation 102-2 of Rule 102 [sec. 102 par. .03].

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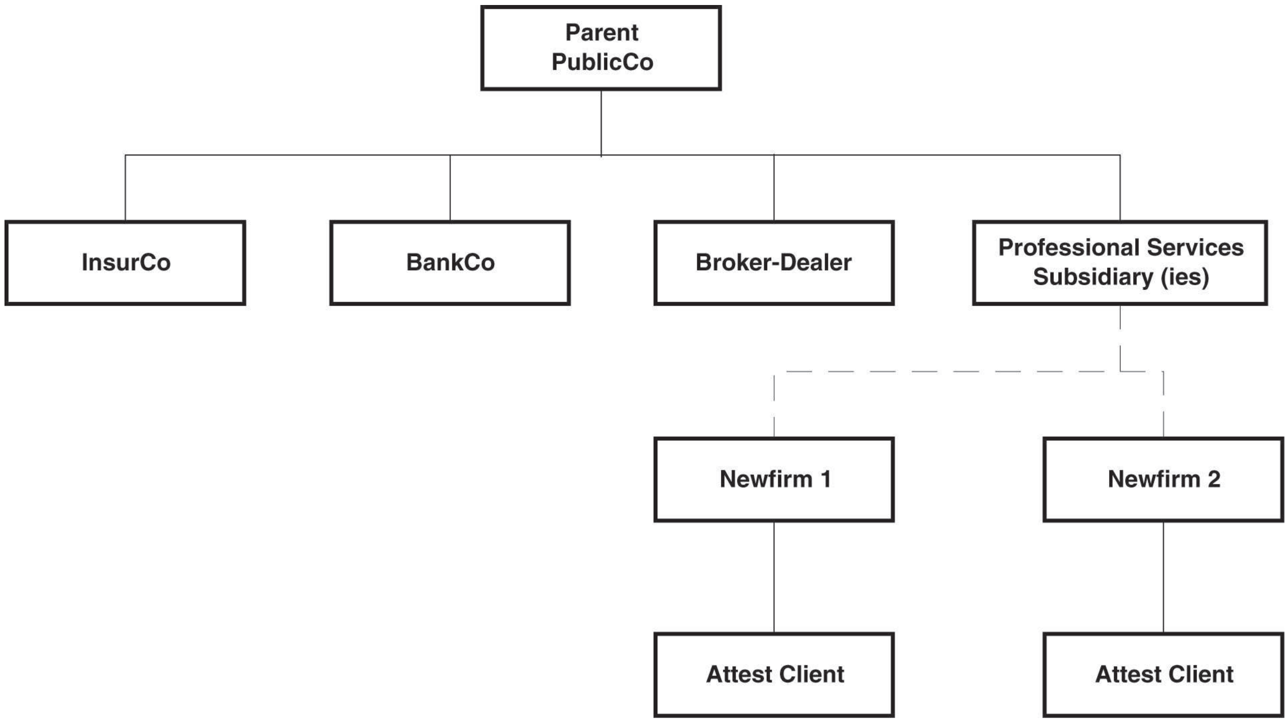
[3] For purposes of this interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner, or director, (2) being in a policy-making position such as CEO, chief operating officer, CFO, or chief accounting officer, or (3) meeting the criteria in FASB ASC 323-10-15 to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

[4] For purposes of this interpretation, significant influence means having the ability to exercise significant influence over the financial, operating, or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner, or director, (2) being in a policy-making position such as CEO, chief operating officer, CFO, or chief accounting officer, or (3) meeting the criteria in FASB ASC 323-10-15 to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

Alternative Practice Structure (APS) Model



[*The next page is 10,261.*]

AAM Section 10,250

Statement on Quality Control Standards

Statements on Quality Control Standards (SQCSs) are issued by the Auditing Standards Board. Firms that are enrolled in an AICPA approved practice-monitoring program are obligated to adhere to quality control standards established by the AICPA.

Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10)

Supersedes SQCS No. 7. SQCS Nos. 2–6 were previously superseded by SQCS No. 7. SQCS No. 1 was previously superseded by SQCS No. 2.

Effective date: Applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2012.

[*Refer to section 10,200 appendix A for reprint*.]

[*The next page is 10,281.*]

AAM Section 10,280

Interpretation No. 101-14 of Rule 101, Independence

Interpretation No. 101-14, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .16)

[*Refer to section 10,200 appendix B for reprint.*]

[*The next page is 10,301.*]

AAM Section 10,300

Sample Quality Control Forms

.01 The following are sample documents and forms that practitioners may find useful.

.02 Independence and Representation Checklist for Other Auditors

Office ________________

Firm name ______________

In order to determine that your firm is in compliance with the independence standards, regulations, interpretations and rulings of the AICPA, the [*name of State*] CPA Society, the [*name of State*] Board of Accountancy, and [*name of State*] statutes the following must be completed by _____ [*date*] and returned to _____ as noted. If there are any questions you have related to the completion of the form, or if there is a matter that has come to your attention which may impair your firm's independence, please contact [*name of Partner*] to resolve the problem.

	Yes	***No***
1. We are aware that [*Name of primary auditor*] has been engaged to audit the financial statements of [*Name of parent*] as of [*Date*] and for the [*period, for example, year*] then ended.	_____	_____
2. We are aware that [*Name of primary auditor*] plans to rely on our audit of the financial statements of [*Name of subsidiary or component*] as of [*Date*] and for the [*period, for example, year*] then ended.	_____	_____
3. [We are aware that the primary auditor will refer to our report in their report.]	_____	_____
4. We are independent with respect to [*Name of both the parent and subsidiary or component.*]	_____	_____

______________________________ ______________________________

Partner of other audit firm Date

Reviewed by:

____

Partner of primary audit firm

.03 Scheduling Request

Client ____________________ Engagement No. __________ Year End __________

Partner ____________________ Manager ______________ Tax Ptr/Mgr ________

Personnel Requested	Experience Level	Interim			Year End			Total Hours
		From	Thru	Hours	From	Thru	Hours	

Audited? Yes______ No ______

SEC? Yes______ No ______

Reviewed? Yes______ No ______

Compiled? Yes______ No ______

Attestation? Yes______ No ______

Industry ____________________

Estimated total hours:

Partner ______________

Manager ______________

Staff ______________

Total

Can dates be adjusted? Yes _____ No______ Explain ______________

Can personnel be changed? Yes _____ No______ Explain ______________

Comments ____

____

____

Requested by ______________ Date __________ Scheduled __________ Date ______

Assignment Manager

.04 History of Staff Assignments

NAME ____________________________

				ASSIGNMENT DESCRIPTION				
	DATES							
CLIENT/ LOCATION	INTERIM	YEAR END	RESPONSIBILITY LEVEL	TOTAL HOURS	INDUSTRY	SEC	AUDIT AREAS PERFORMED	REPORTED TO

.05 Client History of Personnel Assigned

CLIENT ______________________________ **LOCATION** ____________________

YEAR ENDING __________________ **AUDITED? YES** ________ **NO** ________ **SEC? YES** ___________ **NO** ___________

FISCAL YEAR	HOURS		ENTER NAMES AND CHARGEABLE HOURS FOR THE YEAR							
	INTERIM	YEAR END	PARTNER	MANAGER	SENIOR	IN-CHARGE	STAFF	STAFF	STAFF	STAFF

.06 Scheduling Master Plan

MONTH OF ______

			Nonworking hours							Nonrecurring assignments				Hours for month		
Staff member	Carry forward	Month assign-ments	Vacation	Holiday	Prof dev.	Comp time	CPA exam	Admin	Other	Tax dept	Review dept	Other client #	Other hr	Total assign	Avail-able	(Over) under
Aston	XX	XX	XX	X	X		X					XXXXXX	X	XXX	X	XX
Barry	XX	X	XX	X	X			X	X					XXX	XX	X
Casey	X	X	X	X					X	X				XXX	XX	XX
Davis	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	XX	(XX)
Evans	X	X	X	X	X	X						XXXXXXX	XX	XXXX		(XX)
Frank	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	X	(XX)
Louis	XX	X	XX	X	X	X		X		X				XXX	XX	XX
Miceli	XX	X	XX	XX	X	X	X	X						XXX	XX	XX
Total	XXXX	XX	XXX	XXX	XX	XX	XX	XX	XX	XX	XX		XXX	XXX	XXX	XXX

.07 Consultation Log

						MEMORANDUM	
DATE	MODE OF COMMUNICATION	CLIENT	OFFICE	REQUEST	RESPONSE	REQUIRED YES/NO	DATE REC'D
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____

.08 Consultation Worksheet

DATE ____________________

CLIENT NAME ____________________

LOCATION ____________________

ENGAGEMENT (TYPE) ____________________

SUBJECT (QUESTION) ____________________

CONSULTANT'S RESPONSE: (Cite professional literature discussed and conclusion of consultant) ______

FINAL RESOLUTION ____________________

____
Senior/Manager

____
Date

____
Partner

____
Date

.09

PRE-EMPLOYMENT APPLICATION

NAME	DATE
ADDRESS	
TELEPHONE NUMBER	SOCIAL SECURITY NUMBER

POSITION APPLIED FOR

FIRST CHOICE	SECOND CHOICE	MINIMUM SALARY REQUIRED: $

☐ Full Time ☐ Permanent Part Time ☐ Temporary ☐ Summer Temporary

REFERRED BY

☐ Newspaper ad ________ ☐ Agency ________ ☐ Friend ________ ☐ Other ________

NAME NAME NAME NAME

EDUCATIONAL BACKGROUND — ☐ See Below ☐ See Attached Resume

	NAME & LOCATION OF SCHOOL	MAJOR COURSE	YEARS ATTENDED		YEAR GRAD.
			FROM	TO	
Elementary					
High or Vocational					
Business or Technical					
College					
Graduate					

ADDITIONAL SKILLS OR MACHINE KNOWLEDGE ☐ See Below ☐ See Attached Resume

Note: See the AICPA *Management of an Accounting Practice Handbook* for an alternative.

EMPLOYMENT HISTORY — ☐ See Below ☐ See Attached Resume List present (or if currently unemployed, most recent) position first.

FROM	TO	EMPLOYER'S NAME	EMPLOYER'S ADDRESS	POSITION OR TITLE	SUPERVISION	REASON FOR LEAVING

USE THIS SPACE TO ACCOUNT FOR PERIODS NOT WORKED	ADDITIONAL INFORMATION HELPFUL IN CONSIDERING EMPLOYMENT

AGREEMENT

"I certify that the information given by me in this application is true in all respects, and I agree that if employed and it is found to be false in any way, that I may be subject to dismissal without notice, if and when discovered. I authorize the use of any information in this application to enable ________________ to verify my statements, and I authorize ________________, past employers, doctors, all references and any other persons to answer all questions asked by ________________ concerning my ability, character, reputation, and previous employment record. I release all such persons from any liability or damages on account of having furnished such information. I further agree, if employed, that (i) I am to work faithfully and diligently, to be careful and avoid accident, to come to work promptly, and I am not to be absent for any reason without prior notice to my supervisor, (ii) upon termination of employment, ________________ may answer all questions asked of any prospective employer concerning my ability, character, reputation and employment record. I agree to submit to a physical examination whenever requested by ________________ and, if employed, I agree to abide by all present and subsequently issued personnel policies and rules of ________________."

APPLICANT'S SIGNATURE: ________________ DATE: ________________

.10 Interview Report

DAY ______________

DATE ______________

TIME ______________

NAME OF APPLICANT ____

POSITION APPLIED FOR ____

COMMENTS BY INTERVIEWER:

RECOMMENDED ACTION:

INTERVIEWED BY: ______________________ TITLE: ______________________

PLEASE RETURN TO HUMAN RESOURCES AS SOON AS POSSIBLE

Note: See the AICPA *Management of an Accounting Practice Handbook* for an alternative.

.11 Record of Professional Development

Name____ Employee No.________________

Out-of-Office Courses:

	Sponsor	Course description	No. of hours	Date completed
1.	______	______	___	______
2.	______	______	___	______
3.	______	______	___	______
4.	______	______	___	______
5.	______	______	___	______
6.	______	______	___	______
7.	______	______	___	______
8.	______	______	___	______
9.	______	______	___	______
10.	______	______	___	______

In-House Programs:

	Instructor	Course description	No. of hours	Date completed
1.	______	______	___	______
2.	______	______	___	______
3.	______	______	___	______
4.	______	______	___	______
5.	______	______	___	______
6.	______	______	___	______
7.	______	______	___	______
8.	______	______	___	______
9.	______	______	___	______
10.	______	______	___	______

.12 20XX Professional Development

Summary *(in hours)*

		In-house presentations			
		Developed in-house	Purchased programs	Outside courses	Total
Partners/Owners					
1.					
2.					
3.					

		In-house presentations			
		Developed in-house	Purchased programs	Outside courses	Total
Professional staff					
1.					
2.					
3.					
4.					
5.					
6.					
7.					
8.					
Paraprofessionals					
1.					
2.					
3.					
4.					

.13 20XX Professional Development

Summary *(in dollars)*

		Purchased programs for in-house use	Outside courses	Total
Partners/Owners				
1.		$	$	$
2.				
3.				
Professional staff				
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
Paraprofessionals				
1.				
2.				
3.				
4.				

.14 Performance Evaluation

[To be completed after each engagement of 40 hours or more.]

Name ______________________________ Classification ______________

Client ______________________________ From __________ To __________

Describe work assigned: ______________________________

____

____

In your opinion based on the staff member's classification, should this assignment be considered:

Demanding ☐ Routine ☐

This individual is ☐ is not ☐ ready for increased responsibility. Explain ______________

____

Rating: Enter comments which describe the staff member's performance on this engagement. Rate the staff member on each of the items below as Outstanding (O), Very High (VH), Good (G), Below Normal (BN), or Not Applicable (NA).

[Support each caption with specific incidents or remarks.]

Technical Knowledge: Did the staff member possess adequate knowledge to function effectively at the level assigned? Did this knowledge encompass accounting principles, auditing standards, and tax accounting? Has the staff member kept current on recent developments and new pronouncements on professional practice matters as they affected this engagement?

O VH G BN NA

Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Analytical Ability and Judgment: How well did the staff member recognize problems, develop relevant facts, formulate alternative solutions, and decide on appropriate conclusions? Did the staff member distinguish between material and immaterial items? Was the staff member practical in adapting theory and experience to the individual circumstances of this client?

O VH G BN NA

Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Written and Oral Expression: Evaluate the effectiveness of the staff member's letters, memoranda, and other forms of written communication. In conversation, did the staff member communicate intentions effectively? Were instructions understood the first time? Did the staff member sell ideas, obtain acceptance and action?

O VH G BN NA

Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

(continued)

Performance: Can you depend on the staff member for sustained, productive work? Were assignments organized and completed accurately in a reasonable amount of time? Did the staff member readily assume responsibility? Did the staff member meet time estimates and document work papers properly?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

____

____

____

Development of Personnel: In assigning work, did the in-charge member make the most effective use of available talent in terms of getting the work done and in terms of developing staff members performing the work? Did the in-charge staff member tend to make assignments which were either too easy or too hard for his subordinates? Was the staff member readily accepted as a leader? Was the staff member effective in on-the-job coaching?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

____

____

____

Client Relations: How well did the staff member relate to this client and gain his acceptance? How well did the staff member recognize and take advantage of practice development opportunities, through extension of services to this client?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

____

____

____

Attitude: Did the staff member demonstrate a positive and professional approach to the assignment? Was this demonstrated by sustained effort in completing work? Was the assignment undertaken with enthusiasm and zest? Did the staff member respond in a positive way to suggestions and guidance from superiors? To what degree did the staff member make personal sacrifices to meet client requirements? Was the staff member a helpful member of the team? Did the staff member go out of his way to help an associate?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

____

____

____

Personal Characteristics: Did the staff member possess self-confidence and was this confidence projected in an acceptable way? Were positive impressions created with this client and with associates? Did the staff member have a keen sense of what to do or say (tact)? Were clothes appropriate to professional work? Was the staff member well groomed?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

____

____

____

Note: See the AICPA MAP Handbook for alternatives.

Strong points which were evident: ____

____

____

____

____

Recommendations for improvement: ____

____

____

____

____

Comments of Staff Member Being Evaluated: ____

____

____

____

____

Signatures:

Evaluated staff member ______________________________ Date __________

Evaluator ______________________________ Title ______________ Date __________

Engagement manager ______________________________ Date __________

Partner ______________________________ Date __________

.15

JOB EVALUATION REPORT
[For Assignments of Thirty (30) Hours or More]

Name ____

Location ____

Engagement ____

Assistant ____________________ In-Charge _______________

	Compared to Others in Peer Group							
	A	A-	B+	B	B-	C+	C	
	SUPERIOR	EXCELLENT	ABOVE AVERAGE	SATISFACTORY	IMPROVEMENT DESIRED	IMPROVEMENT REQUIRED	UNSATISFACTORY	NOT APPLICABLE
A. PERFORMANCE ON THE JOB								
1. *Technical Ability Demonstrated*								
a) The purpose of the audit procedures planned was understood								
b) Materiality was neither underestimated nor overestimated								
c) Accounting theory and current releases of the profession were applied correctly								
d) Federal and state income tax regulations were applied correctly								
2. *Working Paper Evidence*								
a) Documentation of work performance, including adequate indexing and cross referencing								
b) Sound explanations and conclusions								
c) Use of standard work papers								
d) Legibility								
e) Accuracy — absence of mathematical errors								
3. *Completing This Job*								
a) Meeting planned time estimates								
b) Completing reports and tax returns								
c) Following up the reviewer's comments and making the necessary changes								
4. *Client Reaction on This Job*								
a) Getting along with the client's employees								
b) Interest in the client's business								
B. ENGAGEMENT ADMINISTRATION — (For In-Charge Accountants Only)								
1. *Effectiveness of Proper Planning*								
a) Extent that the scope of the work related to internal control								
b) Developing the work program								
2. *Utilizing Staff Effectively and Efficiently*								
a) Advance planning to minimize crises								
b) Efficient use of staff on the job								
c) On-the-job training of assistants								
3. *Meeting Deadlines*								
a) Completing the engagement in the planned time								
b) Delivering completed pencil copies of the report and tax returns to the supervisor as agreed								
4. *The Product*								
a) Quality of report preparation, including adequate and informative disclosures								
b) Quality of the management advice recommendations								
5. *Practice Management*								
a) Extending service								
b) Ease of collecting for services performed								

.16

Knowledge and Skill Form

(and Profile of Management Role Performance)

_______________________________ Staff member evaluated

_______________________________ Date

_______________________________ Evaluator

Indicate most effective and least effective roles by placing a check in the far left or right hand column (maximum of two each). For the other five traits, indicate relative strength of staff member by placing a check in columns 2, 3, or 4.

(Circle at least two but not more than four in each section and indicate the effectiveness of each trait.)

			If you wish, add your own words.	Effectiveness Least 1	2	3	4	Most 5
Planner								
Careful	Sloppy	Thorough						
Imaginative	Foresighted	Infrequent						
Routine	Erratic	Last-minute						
Constant	Cautious	Meticulous						
Problem solver								
Analytical	Consistent	Superficial						
Critical	Faulty	Routine						
Hasty	Creative	Reliable						
Slow	Quick	Successful						
Communicator								
Warm	Sloppy	Cold						
Inhibited	Weak	Unstructured						
Thorough	Receptive	Patient						
Expressive	Efficient	Precise						
Leader								
Dominating	Excitable	Partial						
Uncertain	Permissive	Energetic						
Weak	Fair	Heavy-handed						
Loose	Amiable	Sure						
Decision maker								
Decisive	Lone	Delayer						
Slow	Avoider	Reliable						
Quick	Seldom	Participative						
Frequent	Rash	Dependent						
Trainer								
Systematic	Unprepared	Conscientious						
Patient	Efficient	Knowledgeable						
Sloppy	Diligent	Disinterested						
Off-on	Slow	Enthusiastic						
Team member								
Cooperative	Unreliable	Independent						
Influential	Divisive	Undisciplined						
Conformist	Reliable	Contributing						
Forceful	Reluctant	Welcome						
Innovator								
Original	Appropriate	Consistent						
Infrequent	Clever	Sensible						
Unnecessary	Creative	Unimaginative						
Constant	Disruptive	Rash						
Job expertise								
Amateur	Improving	Too technical						
Obsolete	Mediocre	Disinterested						
Masterful	Balanced	Lagging						
Versatile	Up-to-date	Thorough						

(Complete Annually)

.17 Employee Annual Performance Appraisal

Time Period Involved			
From	To		☐ EXEMPT
			☐ NON-EXEMPT

Name		Position Title	Number
Hire Date	Present Position Date	Days Absent From: ____________ To: ________ Charged To Sick Time: ________________ Disability: ________________	

Strengths	Development Needs
	Suggested Plan for Performance Improvement

Summary

Overall Rating on Having Met Job Requirements	
Non-Exempt - Circle One	Exempt - Circle One
1 2 3	1 2 3 4 5
1 = Did Not Meet Job Requirements	1 = Did Not Meet Job Requirements 2 = Met Most
2 = Met All 3 = Exceeded	3 = Met All 4 = Exceeded 5 = Far Exceeded

Review the following questions before answering them, using the following criteria:

- A *yes* answer should be considered for possible mention as a "strength." If so, refer to it on the first page of this evaluation.
- A *no* answer should be considered for possible mention as a "development need." If so, refer to it on the first page of this evaluation.

All answers should be considered in arriving at an overall rating on having met job requirements.

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Quality of Work					
Is work accurate, neat, and clearly presented?	( )	( )	( )	( )	( )
Carefully planned, well organized, and thorough?	( )	( )	( )	( )	( )
Productivity					
Is a good level of production maintained?	( )	( )	( )	( )	( )
Are deadlines met?	( )	( )	( )	( )	( )
Are pressure situations handled effectively?	( )	( )	( )	( )	( )
Knowledge of Job					
Does the individual know where to get information?	( )	( )	( )	( )	( )
Is the individual used as a source of information by others?	( )	( )	( )	( )	( )
Communication					
Does the individual ask for clarification when necessary?	( )	( )	( )	( )	( )
Does the individual respond to others in a manner that indicates understanding?	( )	( )	( )	( )	( )
Are ideas expressed so that others are able to understand them?	( )	( )	( )	( )	( )
Human Relations					
Does the individual cooperate with others to get the job done?	( )	( )	( )	( )	( )
Does the individual demonstrate tact and courtesy in dealing with others?	( )	( )	( )	( )	( )
Does the individual maintain a good working relationship with all others?	( )	( )	( )	( )	( )
Are questions and requests dealt with in a helpful manner?	( )	( )	( )	( )	( )
Need for Supervision					
Can the individual be relied upon to get work done without close supervision?	( )	( )	( )	( )	( )
Does the individual take the initiative when appropriate?	( )	( )	( )	( )	( )
Problem Solving					
Does the individual collect the data needed to solve problems?	( )	( )	( )	( )	( )
Are problems solved quickly?	( )	( )	( )	( )	( )

(continued)

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Problem Solving—cont'd					
Are solutions reasonable and accurate?	( )	( )	( )	( )	( )
Does the individual know when to ask for advice and whom to ask?	( )	( )	( )	( )	( )
Does the individual seek out methods to do work more efficiently?	( )	( )	( )	( )	( )
Are alternate solutions generated when appropriate?	( )	( )	( )	( )	( )
Work Habits					
Does the individual comply with the AICPA's established work hours?	( )	( )	( )	( )	( )
Does the individual provide proper notification when absent from work?	( )	( )	( )	( )	( )
Personal Development					
Does the individual try to expand on required knowledge and skills?	( )	( )	( )	( )	( )
Does the individual readily grasp and master the new job requirements?	( )	( )	( )	( )	( )
Does the individual show ambition by building on strengths and working on deficiencies?	( )	( )	( )	( )	( )
Is the individual a good candidate for promotion?	( )	( )	( )	( )	( )
Is the individual ready for promotion at this time?	( )	( )	( )	( )	( )
Supervisory Capabilities					
Does the individual demonstrate the ability to direct and be responsible for the performance of others?	( )	( )	( )	( )	( )
Does the individual effectively evaluate and develop subordinates?	( )	( )	( )	( )	( )
Are subordinates properly motivated?	( )	( )	( )	( )	( )
Are subordinates given reasonable goals and aided in meeting them?	( )	( )	( )	( )	( )
Does the individual comply with administrative and policy guidelines of _________?	( )	( )	( )	( )	( )
Is good judgment exercised in observing budget constraints?	( )	( )	( )	( )	( )
Does the individual maintain adequate discipline in regard to subordinates attendance and punctuality?	( )	( )	( )	( )	( )
Does the individual provide a good example for peers and subordinates to follow?	( )	( )	( )	( )	( )

INCUMBENT REVIEW COMMENTS & ACKNOWLEDGEMENT
I acknowledge that: (1) I have reviewed and discussed this performance appraisal with the preparer. My signature means that I have been advised of my performance evaluation but does not necessarily imply that I agree with it; (2) I have received a copy of the goals/duties that will be used to evaluate my performance during the coming year; and (3) I have reviewed my job description and do ☐ do not ☐ feel it should be revised. My signature and the date I discussed this with the preparer appears below.

Employee	Date

Evaluator/Title	Date

.18 Client/Engagement Acceptance and Continuation Checklist [1]

Note: Acceptance of a new client normally is of critical importance to a small firm. Depending on the type of industry and the services to be provided, accepting a new client can affect nearly all aspects of a firm's quality control system: Are the firm's library and practice aids adequate? Do personnel have appropriate CPE? Does the firm need an outside consultant? The best time to document the acceptance decision is when a new audit or attestation client or engagement is signed, using a form such as the one below.

Name of prospective client: ______________________________

Address and Phone No.: ______________________________

____

Name and title of contact at prospective client: ______________________________

____

Form completed by: ______________________________ Date: ______________

Instructions

This form provides for information necessary to assess whether to accept a prospective client. The information should be obtained from discussions with the prospective client's management, bankers, attorneys, credit services, and if applicable current or former independent CPA, from reviewing the client's financial statements, regulatory agency reports, credit reports, and tax returns, and from other sources such as industry or accounting journals, etc. As much information as possible should be obtained before visiting the potential client. Depending on the type of engagement involved, some information requested on this form may not be applicable, or additional information may be necessary and should be attached.

Services and Reports Required

1. Describe the service and reports requested. ______________________________
____
____

2. Describe the reason the service is needed, including any regulatory requirements or third parties for which the service or report is intended. ______________________________
____
____

3. What is the required completion date? ______________________________
____

4. Describe any other services not requested for which there appears to be a need. ______________
____
____

5. What is the preliminary estimate of hours to complete the engagement? ______________
____

6. Has the client imposed any restrictions on the scope of the engagement that might preclude expression of an unqualified report? ______________________________
____
____

7. Do we have the necessary expertise and staff to perform the engagement? (If not, how will we overcome this problem?) ______________________________
____
____

---

[1] Certain items in this checklist have been reprinted from the *Journal of Accountancy*, Copyright © 1997 by AICPA.

Industry Practices and Conditions

8. In what industry does the company operate?____________________

9. Describe any specialized tax or accounting practices applicable to the industry.____________________

10. Describe any economic, technological or competitive conditions or other recent developments in the industry that may affect the company's operations. ____________________

11. Describe any special regulatory requirements applicable to the industry. ____________________

12. Is the company in the development stage? ____________________

Organization and Personnel

13. Company's Legal Name: ____________________ Fiscal Year End: __________

14. Type of legal entity (Corporation, S Corporation, partnership, proprietorship, etc.): __________

15. List the major stockholders (partners or owners) of the company and their percentage of ownership. If applicable, obtain and attach a copy of the company's organization chart.

Name and (if applicable) Title	% Ownership

16. List the principal members of management.

Name and Title	Stated Qualifications (education, training, and experience)

17. Briefly describe any existing or contemplated employee bonus arrangement (individual, title, method of computation), stock option, or pension (profit sharing) plans that may affect the engagement.

18. List each location maintained by the company (including foreign locations, if any), the nature of the activity performed at each, and the approximate number of employees at each, i.e., plant, sales office, executive offices, etc.

Location	Activity	No. of Employees

19. Inquire about possible transactions with related parties that may affect the engagement.

Name of Related Party	Relationship	Type of Transaction

Operations

20. Describe the nature of the company's major assets and liabilities. ________________________

21. What are the company's sources of revenue and marketing methods? Describe major products, customers, etc.). ________________________

22. If the company is economically dependent on a major customer, name the customer and approximate percentage of total revenue generated by this customer. ________________________

23. Describe the components of cost of goods sold and the company's production process. ____________

24. What are the major expenses of the company other than cost of goods sold? ________________________

25. Describe the company's compensation methods, i.e., salary , hourly wage, commissions, piece work, union scale, etc. ________________________

26. What are the company's major sources of financing, i.e., working capital loans, long term debt, leasing, equity, etc. Describe restrictive covenants on any loan agreements. ________________________

27. Is management sufficiently knowledgeable about its activities and financial condition? ____________

28. Does it appear that the entity's activities or resources are heavily concentrated in one or a few high-risk areas? ________________________

Accounting

29. Does the company maintain the following items? [Attach description, if appropriate.]
    a. Accounting manual? ______________________________
    b. Budget? ______________________________
    c. Cost accounting system? ______________________________
    d. Information technology? (indicate type of equipment and software) ______________________________
    ____
    e. Written credit policy? ______________________________

30. Briefly describe the accounting system and accounting responsibilities.

Description of Accounting Record	Name of Person Who is Responsible	Information Technology	Manual	N/A
General Ledger	________	________	________	____
Subsidiary Ledgers:				
Accounts receivable	________	________	________	____
Fixed assets	________	________	________	____
Loans payable	________	________	________	____
Accounts payable	________	________	________	____
Perpetual inventory	________	________	________	____
Physical inventory summarization	________	________	________	____
________	________	________	________	____
________	________	________	________	____
________	________	________	________	____
Journals:				
Cash receipts	________	________	________	____
Cash disbursements	________	________	________	____
Sales/purchase/voucher	________	________	________	____
Payroll	________	________	________	____
General journal entries	________	________	________	____
________	________	________	________	____
________	________	________	________	____
________	________	________	________	____
Financial Reporting [Indicate basis of accounting]:				
Annual financial statements	________	________	________	____
Monthly financial statements	________	________	________	____
Management reports	________	________	________	____
________	________	________	________	____
Other:				
Bank reconciliations	________	________	________	____
________	________	________	________	____

31. Describe the company's completeness procedures and methods to insure that accounting transactions enter into the accounting system, i.e., that all shipments or services are invoiced, that all cash sales are recorded, and that all disbursements are recorded. ______________________________
    ____
    ____

32. Describe any unusual features of the accounting system. ______________________________
    ____
    ____

33. Are sufficient records available to perform the engagement? ____________________

34. Is management sufficiently knowledgeable about applicable accounting principles? ____________________

35. Does management understand accounting matters adequately to assume responsibility for proper valuation, presentation, and disclosure? ____________________

Tax Matters

36. Who prepares the tax returns? ____________________

37. Describe major differences between book and tax income, unusual tax elections, carry forwards or IRS examinations in process. If possible, review copies of the most recent 3 years of tax returns and attach them to this form. ____________________

Other Matters

38. Describe any significant problems that could affect the engagement, such as litigation or other contingencies, unusual agreements, and plans to acquire or dispose of significant assets, merge with another entity, enter a new area of business, convert to or expand use of information technology, etc. ____________________

39. Give the name of a current or former independent CPA. ____________________

    a. Describe any disputes over accounting matters. ____________________

40. Describe any apparent problems or areas for improvement that were noted where our firm could provide additional service or recommendations. ____________________

41. Is the client relatively free from controversy and media coverage? ____________________

Independence

42. Would service to this client cause problems of independence or conflicts of interest because of relationships with other clients or members of the staff? ____________________

Fees

43. Based on inquiries with a current or former independent CPA, if applicable, indicate the amount of any unpaid fees and the reason for nonpayment. ____________________

44. If possible indicate the amount of fees charged by an existing or former independent CPA for the service being proposed. (The CPA or the potential client may be willing to furnish this information, or it might be obtainable from the financial statements or tax return.)________________

45. Describe any other indications that our firm might have a problem billing or collecting our fees. _____

46. Does the prospective fee justify pursuing this engagement? ________________

Management Integrity

47. Have any of the following sources raised any concerns about management's integrity?
    a. Difficulty in obtaining information from management, or evasive, guarded or glib responses to inquiries. ________________

    b. Apparent difficulty in meeting financial operations or a deteriorating financial position that might predispose management to commit fraud or make a misrepresentation. ________________

    c. Disputes about accounting principles, engagement procedures or similarly significant matters with an existing or former accountant, or doubts of the predecessor accountant about management's integrity. ________________

    d. Comments by bankers, attorneys, creditors, or others having a business relationship with a potential client. ________________

48. If management is changing accountants, why is the change being made, and is the reason for the change acceptable? ________________

49. Is there any reason to suspect that management would be uncooperative, unreasonable or otherwise unpleasant to work with? ________________

50. Does the general integrity of the client seem satisfactory? ________________

Other Comments or Observations

51. Give any other comments or observations that might affect our decision whether to prepare a proposal letter or its contents. Add attachments to this form, if necessary. ________________

Conclusion

52. Should we accept/continue this client/engagement? ________________

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Summary Control Checklist

Firm Name ______________________
Quality Control Monitoring System Summary

Year Ended ______________________

Monitoring Procedure	Reviewed By	Reviewed Date	Location of Documentation
Analysis of the relevance of new professional pronouncements			
Continuing professional education and other professional development activities			
Independence confirmations			
Client/engagement acceptance and continuation decisions			
Interviews of firm personnel			
Review of engagements			
Inspection (describe procedures performed)			
Other procedures (describe)			
Determine that the above procedures have adequately considered and evaluated:			
1. The firm's management philosophy.			
2. Its practice environment.			
3. The relevance and adequacy of firm policies and procedures.			
4. Compliance with firm policies and procedures.			
5. Appropriateness of the firm's guidance materials and practice aids.			
6. Effectiveness of professional development activities.			

.20 Summary Monitoring/Inspection Report

I. *Planning the Inspection*

A. Inspection period

____

B. Composition of Inspection Team:

1. Captain__________________ Position __________________
2. Team Member__________________ Position __________________
3. Team Member__________________ Position __________________

C. Indicate matters that may require additional emphasis in the inspection and explain why.

____
____
____
____
____

D. Development of Inspection Program:

1. Describe programs used and indicate any deviations therefrom.

____
____
____
____

2. Describe basis for selection of engagements:

____
____
____

E. Timing of Inspection:

Commencement

____

Completion of work

____

Issuance of report

____

II. *Scope of Work Performed*

A. Indicate elements of quality control not addressed and give reasons.

____
____
____
____

B. Engagements Reviewed:

	Firm Totals		Engs. Reviewed	
	Hrs.	No. of Engs.	Hrs.	No. of Engs.
Audits:				
SEC Clients				
Government[2]				
ERISA				
Other				
Reviews				
Compilations				
Attestations				
Other Accounting Services	________	____________	________	____________
	________	____________	________	____________
	________	____________	________	____________

Comments:

III. *Engagement Conclusions*

A. Did the inspection disclose any situation that led the reviewers to conclude that the firm or office should consider:

1. Taking action to prevent future reliance on a previously issued report, pursuant to SAS No. 1 (AICPA, *Professional Standards*, AU sec. 561)? Yes ____________ No ____________

2. Performing additional auditing procedures to provide a satisfactory basis for a previously expressed opinion, pursuant to SAS No. 46 (AICPA, *Professional Standards*, AU sec. 390)? Yes ____________ No ____________

B. Did the inspection team conclude in any instances that the firm or office lacked a reasonable basis under the standards for accounting and review services for the report issued? Yes ____________ No ____________

If any of the answers above are *yes*, attach a description of such situations, including actions the firm or office has taken or plans to take.

[2] Includes only audits conducted pursuant to the *Government Auditing Standards*, issued by the Comptroller General of the United States (Yellow Book).

IV. *Findings and Recommendations:*

Attach a copy of any reports issued, including a summary of any inspection findings and recommendations for improvement or list such findings and recommendations below.

____
____
____
____
____
____
____

Supervisory Partner______________________________

Date______________________________

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> ***Note:*** A firm should make the analysis and assessment of the relevance of new professional pronouncements that can affect its practice, and consequently its quality control system, an ongoing activity. The AICPA's *Journal of Accountancy* publishes many of the new pronouncements in its Official Releases column. Thus, a practitioner can review the new pronouncements monthly (or after tax season for the first three months of the year) and record that review on a checklist similar to the one below.

New Pronouncements Checklist

Firm Name__________________
Analysis of New Professional Pronouncements
The purpose of this checklist is to document the firm's analysis and assessment of the relevance of new professional pronouncements to the firm practice.

		Reviewed		Relevant?		
Professional Pronouncement	**Effective Date**	**By**	**Date**	**Yes**	**No**	**Comment, Reference**
Auditing Standards Statement on Auditing Standards No. 125, *Alert That Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*, AU-C sec. 905)	For auditor's written communications related to audits of financial statements for periods ending on or after 12/15/12					
Attestation Standards						
Auditing Interpretations						
Attestation Interpretations						
Standards for Accounting and Review Services						
Other AICPA Official Releases Technical Question and Answer section 9160.28, "Combining a Going Concern Emphasis With Another Emphasis-of-Matter Paragraph" (AICPA, *Technical Practice Aids*)	May 2012					
Other Professional Pronouncements Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (2011 revisions issued on	For audits of financial statements and attestation engagements for periods ending on					

New Pronouncements Checklist						
Firm Name__________________ Analysis of New Professional Pronouncements The purpose of this checklist is to document the firm's analysis and assessment of the relevance of new professional pronouncements to the firm practice.						
		Reviewed		**Relevant?**		
Professional Pronouncement	**Effective Date**	**By**	**Date**	**Yes**	**No**	**Comment, Reference**
December 21, 2011, by the Comptroller General of the United States)	or after December 15, 2012 (for performance audits beginning on or after December 15, 2012). Early adoption is not permitted.					
Financial Accounting Standards Board Accounting Standards Update No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*	For issuers: Fiscal years, and interim periods within those years, beginning after 12/15/11 For nonissuers: Fiscal years ending after 12/15/12					
Governmental Accounting Standards Board						
Other Pronouncements						

[*The next page is 20,001.*]

AAM TOPICAL INDEX

References are to section and paragraph numbers.

[*Reserved*.]

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- IFRS Financial Statements: Best Practices in Presentation and Disclosure
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