

AUDITING & ATTESTATION

CPA2902US3-37

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From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.

ABOUT UPDATING SUPPLEMENT VERSION 37.3

This supplement is designed to bring the very latest information to candidates using our products in preparation for the CPA exam in the October-November 2008 and later exam windows. Candidates with the 37th edition CPA Review textbook or the corresponding Version 11 series software will find the information in updating supplement Version 37.3 more than adequate for these exam windows.

When new information first becomes available, the examiners tend to test new or changed portions of concepts lightly. Coverage of information after that point may increase, if it is in a heavily tested area. Do not fall into the trap of attaching undue significance to new information merely because it is new.

Accounting and auditing pronouncements are eligible to be tested on the CPA exam in the testing window beginning six months after a pronouncement's *effective* date, unless early application is permitted. When early application is permitted, a new pronouncement may be tested in the window beginning 6 months after the *issue* date. In this case, *both* the previous and the new pronouncements can be tested until the previous pronouncement has been superseded.

Remember, with the information and techniques in our material, passing the exam is an attainable goal. ***Adhere to a reasonable study plan—and pass the first time!***

STUDY OPTIONS AVAILABLE TO CANDIDATES

As every candidate's needs are different, Bisk Education offers a variety of CPA Review formats and packages that are guaranteed* to help you pass the CPA exam on your next sitting. Options include: our Online CPA Review with structured Internet classes and our self-study CPA Review utilizing multimedia CD-ROM software, video lectures, audio lectures, and books.

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OTHER SOURCES OF INFORMATION FOR CANDIDATES

Candidates choosing to use previous editions of our textbooks must accept responsibility for adequately updating their materials and should consider the strain this will add to the already time-consuming process of studying for the exam. Candidates with the 35th and earlier editions are strongly encouraged to purchase new materials. Please contact a customer service representative at 1-800-280-9718.

Candidates with the 36th edition of the textbook or corresponding Version 10 series software will also need AUD Updating Supplement Version 36.2. AUD Updating Supplement Version 36.2 contains summaries of SAS Nos. 113 and 114, SSAE 14, and *Government Auditing Standards*, 2007 Revision. (This content is incorporated into the 37th edition.)

NEW RESEARCH TASK FORMAT

A new Uniform CPA Examination research question response format is scheduled to be introduced in the **July-August 2008** exam window. This new format simplifies the way candidates respond to a research question. Candidates will no longer need to copy their response by selecting the proper paragraph and using "TRANSFER TO ANSWER." The new format will require candidates to identify the correct response much like they select answers to multiple-choice questions.

The question, authoritative literature, and response control will be on a single tab. The tab will be called "Research/Authoritative Literature" in all 3 exam sections with simulations. The Standards tab (in AUD and FAR) and the Code tab (in REG) have been replaced by the Research/Authoritative Literature tab. Help for the research response format is on the same tab and directions for using the new research response format are available by clicking on the "View Directions" link at the top of the tab.

Candidates will no longer need to worry about splitting the screen. The question will appear at the top of the screen and then have 3 panels underneath so that everything will appear on the same screen. The left panel will have authoritative references, the center panel will show the reference search results, and the right panel will display the answer choices. When the candidate navigates to a document, either by searching or clicking in the Table of Contents, the answer pane will update itself with all possible responses in that document. A candidate will simply have to click on a radio button to respond.

The AICPA posted new tutorial and sample tests on the CPA Examination website, www.cpa-exam.org, in May of 2008. Candidates planning to test on or after **July 1, 2008**, should log onto the site and become familiar with this new functionality.

RECENT PRONOUNCEMENTS

PCAOB AS 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (issued 7/07)

This standard was eligible to be tested beginning in the April-May 2008 exam window. Only the new standard was testable starting with the April-May 2008 exam window.

This auditing standard superseded PCAOB (Public Company Accounting Oversight Board) Auditing Standard (AS) 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*.

The Securities and Exchange Commission (SEC) approved PCAOB AS 5, a related independence rule (Rule 3525) and conforming amendments (File No. PCAOB-2007-02) on July 27, 2007. They were effective and required for integrated audits required by Section 404(b) of the Sarbanes-Oxley Act of 2002 conducted for fiscal years ending on or after November 15, 2007. Early adoption was permitted and encouraged.

PCAOB Rule 3525 requires registered public accounting firms requesting the preapproval of allowed nonaudit services (as required by the Sarbanes-Oxley Act of 2002) to provide the issuer client's audit committee with a description, in writing, of the scope of nonaudit services related to internal control over financial reporting. The auditors must also discuss with the audit committee the potential effects of the service on the independence of the audit firm and then document this discussion.

The conforming amendments updated the PCAOB's other auditing standards with changes resulting from the adoption of PCAOB AS 5. Chapter 29, V. "Reporting on Whether a Previously Reported Material Weakness Continues to Exist" of the textbook contains several references to PCAOB AS 2 as a whole. These should be replaced with references to PCAOB AS 5.

The SEC also adopted a definition of the term *significant deficiency*, defining it as "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting."

Editor's notes:

- (1) The SEC uses "ICFR" as the acronym for *internal control over financial reporting*. The Bisk AUD textbook uses "ICOFR" in the 37th and previous editions—future AUD Bisk textbooks and this updating supplement will conform to the SEC's usage.
- (2) Per PCAOB AS 5, if a company does not have an audit committee, any reference to the audit committee in this standard applies to the entire board of directors of the company.

Overview

Purpose PCAOB AS 5 is applicable to audits of a company (an issuer of securities) subject to the reporting requirements of the Securities Exchange Act of 1934. It establishes requirements and provides guidance for auditors engaged to audit management's assessment of the effectiveness of ICFR that is integrated with an audit of the financial statements. Effective ICFR provides reasonable assurance that the financial reporting process and the preparation of the financial statements are reliable for external purposes.

Auditor's Objective The objective of the auditor for this type of engagement is to express an opinion on the effectiveness of the company's ICFR as of a point in time and taken as a whole.

To express an opinion as of a point in time, the auditor must obtain evidence that ICFR has operated effectively for a sufficient period of time which may be less than the period covered by the company's financial statements.

To express an opinion on ICFR as a whole, the auditor must obtain evidence about the effectiveness of selected controls over *all* relevant assertions. This involves testing the design and operating effectiveness of controls that in most cases would **not** be required if *only* expressing an opinion on the financial statements. During an audit of financial statements, when the auditor's risk assessment of specific financial statement assertions includes an expectation of the operating effectiveness of the relevant controls, evidence must be obtained that these controls were effective for a particular time (or throughout the period) upon which s/he plans to rely on them. The auditor's risk assessment, during a financial statement audit, would ordinarily **not** include an expectation of the operating effectiveness of controls for *all* relevant assertions.

Material Weaknesses If one or more material weaknesses exist, a company's ICFR is not effective. Therefore, the auditor must plan and perform the audit to obtain evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date of management's assessment.

There may be a material weakness in ICFR even when financial statements are not materially misstated.

Indicators of material weaknesses 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
- Auditor identification of a material misstatement of current period financial statements that would not have been detected by the company's ICFR
- Ineffective oversight by the company's audit committee of external financial reporting and ICFR

Standards & Criteria The three GAAS general standards (AU 150.02) are applicable to an audit of ICFR. PCAOB AS 5 establishes the applicable fieldwork and reporting standards.

The auditor should use the same appropriate, established control framework to perform an audit of ICFR as the company's management uses in its annual evaluation of the effectiveness of ICFR.

Definitions

Control Objective "A *control objective* provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide

reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.”

Deficiency “A *deficiency* in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.”

Financial Statements and Related Disclosures “*Financial statements and related disclosures* refers to a company’s financial statements and notes to the financial statements as presented in accordance with generally accepted accounting principles (GAAP). References to financial statements and related disclosures do not extend to the preparation of management’s discussion and analysis or other similar financial information presented outside a company’s GAAP-basis financial statements and notes.”

Internal Control Over Financial Reporting “*Internal control over financial reporting* is a process designed by, or under the supervision of, the company’s principal executive and principal financial officers, or persons performing similar functions, and effected by the company’s board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that:

- (1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company assets that could have a material effect on the financial statements.

Note: The auditor’s procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company’s internal control over financial reporting.

Note: Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.”

Management’s Assessment “*Management assessment* is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management’s annual report on internal control over financial reporting.” It is described therein as “Management’s assessment of the effectiveness of the registrant’s internal control over financial reporting as of the end of the registrant’s most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the registrant’s internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant’s internal control over financial reporting is effective if there are one or more material weaknesses in the registrant’s internal control over financial reporting;...”

Material Weakness “A *material weakness* is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.

Note: There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either ‘reasonably possible’ or ‘probable,’ as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies (‘FAS 5’)*.” *Reasonably possible* is defined therein as “...more than remote but less than likely.” *Probable* is defined therein as “...likely to occur.”

Preventive or Detective Controls “Controls over financial reporting may be *preventive controls* or *detective controls*. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- (1) Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.
- (2) Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.”

Relevant Assertion “A *relevant assertion* is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is based on inherent risk, without regard to the effect of controls.”

Significant Account or Disclosure “An account or disclosure is a *significant account or disclosure* if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.”

Significant Deficiency “A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.”

Integrating the Audits

Although an audit of ICFR and an audit of financial statements have distinct objectives, the auditor must plan an integrated approach and perform the work so that the objectives of both are achieved.

The tests of controls should be designed to *simultaneously* meet the objectives of both audits—to obtain sufficient evidence to support both the auditor’s opinion on ICFR as of year-end and the auditor’s control risk assessments during the audit of financial statements. During an audit of the financial statements, when making a determination of the effectiveness of controls to assess control risk, the auditor should consider the results of the additional tests of controls that were performed in order to express an opinion on ICFR. Likewise, during an audit of ICFR, the results of any additional tests of controls performed to support the opinion of the financial statements should be considered.

Although some procedures performed in an audit of ICFR may reduce the work needed during an audit of financial statements, the auditor must perform substantive procedures for all relevant assertions. This requirement for an audit of financial statements is not diminished by the procedures performed during an audit of ICFR. And in a similar vein, the absence of misstatements detected by substantive procedures in an audit of financial statements is no substitute for the direct testing of controls required by an audit of ICFR. However, their absence should be taken into consideration by the auditor when making risk assessments that underlie the decisions about the testing needed to determine the effectiveness of controls in an audit of ICFR.

Planning

Audit Procedure Considerations The following matters should be considered to determine if and if so, how, they will impact the auditor's procedures and risk assessment:

- Knowledge of the company's ICFR obtained during previous engagements
- Industry issues, such as
 - financial reporting practices
 - economic conditions
 - laws and regulations
 - technological changes
- Company-specific issues, such as
 - Its organization
 - Its operating system characteristics and degree of complexity
 - Its capital structure
 - Ongoing legal or regulatory matters
 - Any recent changes in the company and its operations or its ICFR
 - Public information about the company that is relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of its ICFR
- The auditor's preliminary judgments about
 - the effectiveness of ICFR
 - materiality, risk, and other factors related to the identification of material weaknesses
- Consideration of any risks analyzed as part of the auditor's client acceptance and retention evaluation
- Control deficiencies previously communicated to the audit committee or management
- Type and extent of available evidence that is relevant to the effectiveness of the company's ICFR

Role of Risk Assessment The assessment of risk affects all the auditor's decisions. In assessing risk, the auditor should focus on the areas of highest risk—there is no need to test controls when their failure would not result in the reasonable possibility of a material misstatement to the financial statements. The risk that a company's ICFR will fail to prevent or detect a misstatement caused by fraud is usually greater than the risk that it will fail to prevent or detect error.

Scaling the Audit The audit should be adjusted to fit the size and complexity of the company. Smaller and/or less complex companies may address the risks of misstatement and the needed controls differently than more complex companies.

Addressing the Risk of Fraud and Management Override in Selection of Tests of Controls When selecting controls to test, the auditor should consider whether the company's controls sufficiently address the risk of material misstatement due to fraud and management override of other controls.

Using the Work of Others to Reduce the Work Done by the Auditor Assistance can be obtained from internal auditors, other company personnel and third parties. The auditor's decision to use others and the extent to use them should be based on an evaluation of their competence and objectivity. The auditor should also consider the risk associated with the control being tested—the higher the risk, the more important it becomes for the auditor to perform the work.

Materiality The standard directs the auditor of ICFR to use the same guidance for materiality considerations used in planning an audit of financial statements.

Selection of Controls to Test

Overview The standard advocates a "top-down" approach to identify risks and select controls. The auditor should begin at the financial statement level and gain an understanding of the overall risks to ICFR. Then the auditor should evaluate the entity-level controls. Next s/he should identify the significant accounts and disclosures and their relevant assertions. The auditor should then verify her/his understanding of the risks in the company's processes and select for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

Entity-Level Controls Entity-level controls that are important to the auditor's determination of the effectiveness of the company's ICFR must be tested. Depending on their nature and precision, the degree of effectiveness of the entity-level controls can impact both the selection of other controls to be tested as well as the nature, timing and extent of the testing of other controls. Per this standard, entity-level controls include:

- Controls related to the control environment
- Controls over management override of other controls
- The company's risk assessment processes
- Centralized processing and controls, including shared service environments
- Controls to monitor results of operations
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs
- Controls over the period-end financial reporting process
- Policies that address significant business control and risk management practices

Assessment of Control Environment The auditor must determine whether management's philosophy and operating style promote effective ICFR by reflecting their sound integrity and ethical values. The auditor must also determine if the board or audit committee understands and exercises oversight responsibility over ICFR.

Evaluation of Period-End Financial Reporting Process The period-end financial reporting process evaluation by the auditor should include assessing:

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements
- Types of adjusting and consolidating entries
- Effect of and the degree to which information technology (IT) is used
- Who participates from management
- Locations involved
- Nature and extent of the oversight by management, the board of directors, and the audit committee

Identification of Significant Accounts & Disclosures & Their Relevant Assertions The auditor should evaluate both the qualitative and quantitative risk factors related to the financial statement line items and disclosures in order to identify significant accounts and disclosures and their relevant assertions. These risk factors are the same for both an audit of ICFR and an audit of the financial statements as are the significant accounts and disclosures and their relevant assertions—however for various reasons, the audit of financial statements may also involve performing substantive procedures on items that are not identified as part of this significant group.

The components of an account or disclosure might be subject to different risks and thus may require different controls to address these separate risks.

As part of this process, the auditor should also determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor should reflect on scenarios of what could go wrong.

Multiple Locations or Business Units Tests should only be performed at locations that present a reasonable possibility of material misstatement to the *consolidated* financial statements. For other locations or business units, the testing of entity-level controls may be sufficient to provide the needed assurance.

Entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment should be included in the auditor's considerations.

Testing of controls over the reporting of equity method investments would ordinarily **not** extend to the investee's controls.

Understanding Likely Sources of Misstatement The auditor should continue to develop a further understanding of the likely sources of misstatement which s/he started while identifying significant accounts and disclosures and their relevant assertions. The auditor's objectives are to:

- Understand the flow of transactions (including the effect of IT) related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded
- Confirm that all the points within the company's processes at which a material (individually or combined with other misstatements) misstatement could arise have been identified
- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements

The procedures used to achieve these objectives should either be performed by the auditor or under her/his direct supervision due to the degree of judgment required.

An effective method to achieve these objectives is to perform walk-throughs. The auditor follows a transaction from its origin to its reflection in the financial statements, step-by-step, using the same documents and information technology that a company's personnel use. Walk-throughs usually involve a combination of procedures, including inquiry, observation, inspections of documentation and reperformance.

Selection The decision for selection is based on whether a control by itself (or in combination with other controls) sufficiently addresses the assessed risk of misstatement to a given relevant assertion. It is not necessary to test all the controls that address an assertion.

Testing Controls

Testing Design Effectiveness The auditor should test the design of a control by determining whether the control, if performed correctly by persons with the necessary authority and competence, meets the company's control objectives and can be expected to prevent or detect errors or fraud that could result in material misstatements in the financial statements. Walk-throughs that include inquiries of appropriate people, observation of the company's operations, and inspection of documentation will usually suffice.

Testing Operating Effectiveness The auditor should test the operating effectiveness of a control by determining if the control is operating as designed and confirming that it is being performed by a person with the necessary authority and competence. Procedures for this test would include reperformance of the control in addition to inquiries of appropriate people, observation of the company's operations, and inspection of documentation.

Evidence to Be Obtained The evidence obtained is dependent on the nature, timing, and extent of audit procedures performed. Generally, more evidence is required to support the conclusion that a control is operating effectively than is needed when a control is deemed ineffective. The auditor should increase the amount of evidence gathered as the risk associated with a control increases. Per the standard, the following factors affect the risk associated with a control:

- The nature and materiality of misstatements that the control is intended to prevent or detect
- The inherent risk associated with the related account(s) and assertion(s)
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness
- Whether the account has a history of errors
- The effectiveness of entity-level controls, especially controls that monitor other controls
- The nature of the control and the frequency with which it operates
- The degree to which the control relies on the effectiveness of other controls
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in these key personnel
- Whether the control relies on performance by an individual or is automated, i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective

- The complexity of the control and the significance of the judgments that must be made in connection with its operation

Deviations From Controls When deviations from controls are discovered, the auditor should determine the impact on the assessment of the risk associated with the control, the evidence being gathered, and the operating effectiveness of the control. Any *one* control does not necessarily have to operate without any deviation to be considered effective because effective ICFR does not provide *absolute* assurance.

Special Considerations to Reduce Testing for Subsequent Years' Audits The auditor should incorporate knowledge gained in prior years' audits of ICFR into the determination of the nature, timing, and extent of audit procedures selected to test controls. Per the standard, the factors affecting the risk associated with a control in subsequent years' audits includes those listed in the previous "Evidence to Be Obtained" section of this updating supplement plus the following factors:

- The nature, timing, and extent of procedures performed in previous audits
- The results of the previous years' testing of the control
- Whether there have been changes in the control or the process in which it operates since the previous audit

After taking into account these risk factors, the additional information provided in subsequent years' audits may allow the auditor to assess the risk as lower than in the first year and thus reduce the testing in the subsequent audits.

The standard specifically allows the use of a benchmarking strategy (establishment of a baseline) under certain conditions for automated application controls in subsequent years' audits because of their inherent reliability. If the auditor is able to obtain evidence that general controls over program changes, access to programs, and computer operations are effective and continue to be tested; and that there have been no changes to the automated application controls since they were last tested, the auditor may conclude that the automated application controls continue to be effective.

Vary the Testing The auditor should vary the nature, timing, and extent of the testing of controls from one year to another to allow for changes in circumstances as well as to make the audit unpredictable.

Service Organizations The relevant concepts in AU 324, *Service Organizations*, (concerning a company that obtains services from another organization that are part of the company's information system) are applicable to ICFR audits. If, as described in AU 324, the services provided are part of the company's information system, then it follows that they are part of the information and communications component of the company's ICFR. Thus, the auditor should include the activities of the service organization in the determination of what evidence is needed to support her/his opinion.

The auditor should gain an understanding of both the controls of the service organization that are relevant to the company's internal control and the controls of the company over the activities of the service organization. Then the auditor should obtain evidence that the relevant controls are operating effectively.

The auditor may use a service auditor's report on controls placed in operation and tests of operating effectiveness if s/he judges that the report provides sufficient evidence and is satisfied as to the professional reputation, competence and independence of the service auditor. However, the auditor should not refer to the service auditor's report in her/his opinion of ICFR.

Superseded Controls Sometimes management changes controls during the period being audited. The auditor must use professional judgment to determine if testing of the superseded controls is needed.

Evaluating Identified Deficiencies

Severity of the Deficiency The auditor must determine if each control deficiency identified, either individually or in combination, is a material weakness as of the date of management's assessment by evaluating its severity. However, the auditor is not required to search for deficiencies that do not constitute a material weakness. The severity of a deficiency is dependent on:

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement
- The magnitude of the potential misstatement

Severity is not dependent on whether a misstatement has actually occurred. What matters is the lack of effectiveness of a company's controls, i.e., if there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure.

Prudent Official Standard The auditor should set and use a *prudent official* standard to help evaluate the severity of a deficiency, or combination of deficiencies. To do so, the auditor must determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. If this standard is not met, the auditor should consider the deficiency, or combination of deficiencies, to be an indicator of a material weakness.

Compensating Controls The auditor should consider the effect of compensating controls when determining if a deficiency, or combination of deficiencies, constitutes a material weakness. The compensating control should be judged effective enough to prevent or detect a misstatement that could be material in order to be considered to have a mitigating effect.

Management's Written Representations

The auditor should obtain the following written representations from management:

- Acknowledgment of management's responsibility for establishing and maintaining effective ICFR
- Statement that management has performed an evaluation and made an assessment of the effectiveness of the company's ICFR and specifying the control criteria
- Statement that management did not use the auditor's procedures performed during either the audit of ICFR or the financial statements as part of the basis for management's assessment of the effectiveness of the company's ICFR
- Statement of management's conclusion, as set forth in its assessment, about the effectiveness of the company's ICFR based on the control criteria as of a specified date
- Statement that management disclosed to the auditor all deficiencies in the design or operation of ICFR identified as part of management's evaluation, including separately disclosing all such deficiencies that it believes to be significant deficiencies or material weaknesses in ICFR
- Description of any fraud resulting in a material misstatement to the company's financial statements and any other fraud that involves senior management or management or other employees who have a significant role in the company's ICFR
- Statement of whether control deficiencies identified and communicated to the audit committee during previous engagements have been resolved, and specifically identifying any that have not
- Statement whether there were, subsequent to the date being reported on, any changes in ICFR or other factors that might significantly affect ICFR, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses

The standard refers the auditor to AU 333, *Management Representations*, for further guidance on the management representation letter such as who should sign it, the period it covers, and when to obtain an updated letter as these are the same as for an audit of the financial statements.

Communications

Ineffective Oversight In the case where the auditor concludes that oversight by the company's audit committee of external financial reporting and ICFR is ineffective, the auditor must communicate that conclusion, in writing, to the board of directors.

Material Weaknesses The auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. This should be done prior to the issuance of the audit report on

ICFR. If a material weakness has not been included in management's assessment, the auditor should also communicate this fact, in writing, to the audit committee.

Significant Deficiencies The auditor must also communicate, in writing, all significant deficiencies to the audit committee.

Deficiencies The auditor should communicate, in writing, all deficiencies in ICFR to management of which s/he is *aware* -- the auditor is **not** required to perform procedures that are sufficient to identify *all* control deficiencies. The audit committee should be informed by the auditor when this communication to management has been made.

Scope Limitation If the auditor concludes that he or she cannot express an opinion because there has been a scope limitation, the auditor should communicate, in writing, to management and the audit committee that the audit of ICFR cannot be completed. See the "Disclaim an Opinion or Withdraw From the Engagement" section of this updating supplement for further information.

Material Misstatement in Additional Information Included With Management's Report If the auditor determines that the other information included with management's annual report on ICFR contains a material misstatement of fact and if after a discussion with management, management does not remedy it, the auditor should communicate his or her concerns, in writing, to management and the audit committee. See the "Report Modifications" section of this updating supplement for additional information.

Fraud and Illegal Acts The standard refers the auditor to AU 316, *Consideration of Fraud in a Financial Statement Audit*, AU 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934 for guidance regarding the auditor's responsibilities if s/he becomes aware of fraud or possible illegal acts.

Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 is Misstated The standard refers the auditor to AU 722, *Interim Financial Information*, for guidance as to communication responsibilities in this instance. See the "Report Modifications" section of this updating supplement and Chapter 30 of the textbook for additional information on interim financial information.

Auditor Disagrees with Management's Application of SEC's Criteria for Exclusion of Certain Entities from Assessment of ICFR or Finds Management's Disclosure of the Exclusion Inadequate The standard refers the auditor to AU 722, *Interim Financial Information*, for guidance as to communication responsibilities in this instance. See the "Report Modifications" section of this updating supplement and Chapter 30 of the textbook for additional information on interim financial information.

Reporting on Internal Control

Forming an Opinion The auditor should form an opinion of the effectiveness of ICFR after considering the evidence obtained from all sources. In addition to the evidence from the auditor's testing of controls and identification of control deficiencies, this would include misstatements identified during the financial statement audit and the evidence in current reports on ICFR issued by internal auditors or others.

Required Elements of Audit Report Per the standard, the following must be included in the auditor's report on ICFR:

- A title that includes the word *independent*
- A statement that management is responsible for maintaining effective ICFR and for assessing the effectiveness of ICFR
- An identification of management's report on internal control
- A statement that the auditor's responsibility is to express an opinion on the company's ICFR based on her/his audit
- A definition of ICFR as stated in paragraph A5 of the standard (see the "Definitions" section of this updating supplement)
- A statement that the audit was conducted in accordance with the standards of the PCAOB (United States)
- A statement that the standards of the PCAOB require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective ICFR was maintained in all material respects

- A statement that an audit includes obtaining an understanding of ICFR, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances
- A statement that the auditor believes the audit provides a reasonable basis for her/his opinion
- A paragraph stating that because of inherent limitations, ICFR may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate
- The auditor's opinion on whether the company maintained, in all material respects, effective ICFR as of the specified date, based on the control criteria
- The manual or printed signature of the auditor's firm
- The city, and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued
- The date of the audit report

The auditor should **not** issue a report stating that no deficiencies exist because an audit of ICFR does not provide assurance that all deficiencies less severe than a material weakness have been identified.

Separate or Combined Reports The auditor may choose to issue separate reports on the company's financial statements and ICFR or to issue a combined report containing both opinions.

If the auditor issues separate reports, a separate paragraph should be added to each report that cross-references the other report, giving the date and nature of its opinion. The reference in the financial statement report to the ICFR report should also identify the control criteria on which the ICFR opinion is based.

Date of Report The auditor should date the audit report(s) no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. If separate reports on the financial statements and ICFR are issued, the date of the reports should be the same, as the auditor cannot audit ICFR without also auditing the financial statements.

Audit Report on ICFR Included With Filings Under Federal Securities Statutes AU 711, *Filings Under Federal Securities Statutes*, is applicable when the auditor's report is included in registration statements, proxy statements, or periodic reports filed under federal securities statutes.

Report Modifications The auditor should modify the report if any of the following conditions exist:

- Elements of management's annual report on ICFR are incomplete or improperly presented

After forming an opinion on the effectiveness of ICFR, the auditor should review management's presentation on the elements that is required by the SEC to be included in the company's annual report on ICFR. If the auditor determines that any of these elements are incomplete or not properly presented the auditor should add an explanatory paragraph that describes the reasons why the auditor found management's report unsatisfactory.
- Scope limitation (see the "Disclaim an Opinion or Withdraw From the Engagement" section of this updating supplement)
- The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report

When another auditor has audited the financial statements and ICFR of one or more components of a company, the auditor needs to determine whether s/he may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for her/his opinion on ICFR. The standard states that AU 543, *Part of Audit Performed by Other Independent Auditors*, is applicable to this determination by the auditor. If the auditor decides that s/he should be the principal auditor of the financial statements, then s/he must also be the principal auditor for ICFR. The principal auditor's decision whether to make reference in the report on ICFR to the audit of ICFR performed by another auditor is similar to the same decision for financial reporting, so again, AU 543 is applicable.

When the auditor decides to make this reference, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

- There is other information contained in management's annual report on ICFR

If the additional information included by management appears to be part of management's annual report on ICFR, then the auditor should disclaim an opinion on the other information.

If the auditor determines that the other information contains a material misstatement of fact and if after a discussion with management, management does not remedy it, the auditor should communicate her/his concerns, in writing, to management and the audit committee. This standard also refers the auditor to AU 317, *Illegal Acts by Clients* and Section 10A of the Securities Exchange Act of 1934 for further direction because in some circumstances additional action may be required.

- Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 is misstated

The standard refers the auditor to AU 722, *Interim Financial Information*, for guidance as to communication requirements if matters come to her/his attention that convince her/him that modifications to the disclosures about changes in ICFR are needed for the annual certifications to be accurate and to be in compliance with either the requirements of Section 302 of Sarbanes-Oxley Act of 2002 or Securities Exchange Act rules for any interim period. If management and the audit committee fail to respond satisfactorily, the auditor (in addition to the requirements described in AU 722) should add an explanatory paragraph to her/his report on ICFR which explains the reasons s/he believes management's disclosures should be modified.

- The SEC allows management to limit its assessment of ICFR by excluding certain entities and the auditor chooses to do so also.

This situation is **not** considered a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in her/his report, a disclosure similar to management's concerning the exclusion of an entity from both the scope of management's assessment and the auditor's audit of ICFR. If the auditor considers management's application of the SEC's exclusion criteria to be unreasonable or management's disclosure inadequate, the auditor should follow the guidance in paragraphs 29 through 32 of AU 722, *Interim Financial Information*, as to communication requirements. In addition, the auditor should add an explanatory paragraph to her/his report on ICFR which describes the reasons why the auditor believes management's disclosures should be modified.

- The auditor obtains knowledge about subsequent events with respect to conditions that did *not* exist at the date of the assessment, but arose subsequent to that date and before issuance of the auditor's report and had a material effect on the company's ICFR

The auditor should add an explanatory paragraph to her/his report describing the event and its effects or a reference to the disclosure in management's report. For additional information see the "Subsequent Events" section of this updating supplement.

Adverse Opinion If there are one or more material weaknesses, the auditor must express an adverse opinion on the company's ICFR unless the scope of the audit has been limited. (The auditor must either withdraw from the engagement or disclaim an opinion if there are restrictions on the scope of the engagement. See the "Disclaim an Opinion or Withdraw From the Engagement" section of this updating supplement.)

The auditor should include a disclosure in the report as to whether the opinion on the financial statements was affected by the adverse opinion on ICFR.

An adverse opinion report resulting from a material weakness must include the definition of a material weakness (see the "Definitions" section of this updating supplement per paragraph A7 of the standard). The remaining modifications to the report and required actions depend on if and if so, how, the material weakness was also included in management's assessment.

When a material weakness was identified and was included in management's assessment, the report must include a statement that a material weakness was identified and an identification of the material weakness described in management's assessment.

When a material weakness was identified and was included in management's assessment, but the auditor finds that the disclosure is not fairly presented in all material respects, the auditor's report should describe this conclusion and the information needed to fairly describe the material weakness.

When a material weakness was identified, but was **not** included in management's assessment the following items must be included in the auditor's report:

- A statement that a material weakness was identified, but not included in management's assessment
- A description of the material weakness that includes
 - Specific information about its nature
 - The actual and potential effect on the financial statements issued during its existence

Additionally, the auditor should communicate, in writing, to the audit committee that the material weakness was not identified or disclosed in management's assessment.

Disclaim an Opinion or Withdraw From the Engagement

Scope Limitation The auditor may not form an opinion on the effectiveness of ICFR if there have been restrictions on the scope of the auditor's work to the degree that the auditor was unable to apply the procedures necessary under the circumstances. If there has been such a scope limitation the auditor is required to disclaim an opinion or withdraw from the engagement. One example of a scope limitation is when the auditor is unable to obtain written representations from management. In this case, the auditor should also consider the effects of management's refusal on her/his ability to rely on other representations made by management, including those made in conjunction with the audit of the financial statements.

When disclaiming an opinion due to a scope limitation, the auditor's report should:

- Include a statement that the scope of the audit was not sufficient to warrant the expression of an opinion
- Include a separate paragraph(s) that gives the substantive reasons for the disclaimer
- **Not** identify the procedures that were performed **nor** include the description of the characteristics of an audit of ICFR to avoid overshadowing the disclaimer
- Include a description of any material weakness that was identified in the company's ICFR (if the auditor was able to conclude it existed based on the limited procedures applied); this should include specifics about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the material weakness – this description should conform to the requirements in paragraph 91 of the standard for the issuance of an adverse opinion due to a material weakness (covered in the previous "Adverse Opinion" section of this updating supplement); the definition of the term *material weakness* per "Appendix A" of the standard (paragraph A7; see the "Definitions" section of this updating supplement) should also be included

The auditor may issue a disclaimer as soon as s/he determines that a scope limitation will prevent the attainment of evidence sufficient to gain the reasonable assurance needed to express an opinion. No additional work is required by the auditor at this point. The report date is the date that the auditor has gained sufficient competent evidence to support the representations contained in her/his report. The auditor should communicate, in writing, to management and the audit committee that s/he is unable to satisfactorily complete the audit of ICFR.

Effect of Subsequent Event Not Determinable The auditor should disclaim an opinion when s/he cannot determine the effect that a subsequent event (with respect to conditions that existed at the date of the assessment) had on a company's ICFR. For additional information see the "Subsequent Events" section of this updating supplement.

Subsequent Events

Procedures to Identify Subsequent Events Changes in ICFR or other factors that have a material impact on ICFR may occur subsequent to the date that ICFR is being audited but before the date of the auditor's report. As previously covered, the auditor should attain written representations from management relating to subsequent events.

- The auditor should review, for this subsequent period, the following:
 - Internal audit reports
 - Other independent auditor reports of deficiencies in internal control
 - Regulatory agency reports on the company's ICFR
 - Information about the company's ICFR obtained via other engagements

AU 560, *Subsequent Events*, provides direction on subsequent events for a financial statement audit that may also be helpful during an audit of ICFR.

When the Subsequent Event Became Known or Arose *Before* the Issuance of the Auditor's Report:

- **And Did Exist As of the Date of Management's Assessment** If the auditor becomes aware of subsequent events that materially and adversely affect ICFR as of the date of the assessment, the auditor should issue an adverse opinion. If management's assessment states that ICFR is effective, the auditor should follow the guidance described previously under "Adverse Opinion" in this updating supplement per paragraph 2C of "Appendix C" of the standard. If the auditor cannot determine the effect of the event on the company's ICFR, the auditor should disclaim an opinion.
- **And Did *Not* Exist As of Date of Management's Assessment** The auditor may become aware of a subsequent event with respect to conditions that did **not** exist as of the date specified in management's assessment, but arose subsequent to that date and before issuance of the auditor's report. If the subsequent event had a material effect on ICFR, the auditor should add an explanatory paragraph to her/his report that either describes the event and its effect or includes a referral to the disclosure in management's report.

When the Subsequent Event Became Known *After* the Issuance of the Auditor's Report If after the auditor issues the report, s/he becomes aware of a subsequent event that existed as of the report date and that might have affected her/his opinion, the auditor should follow the guidance in AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

SSARS 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services* (issued 7/07)

This statement was eligible to be tested beginning in the April-May 2008 exam window. Only the new guidance was testable starting with the April-May 2008 exam window.

This statement was effective for compilations and reviews of financial statements for periods ending on or after December 15, 2007. Early application was permitted.

This statement eliminated certain references in SSARS to Statements on Auditing Standards in acknowledgment that many practitioners do not perform services at a level higher than compilations and reviews and therefore are unfamiliar with the auditing literature. In place of these references, new or enhanced guidance was provided in the following areas:

- A definition of other comprehensive basis of accounting (OCBOA)
- Appropriate OCBOA financial statement titles
- Reporting examples for compilations and reviews of OCBOA financial statements
- Guidance on emphasizing a matter when reporting on compiled or reviewed financial statements

- Clarification of the accountant's responsibility with respect to facts discovered subsequent to the date of the accountant's compilation or review report
 - Additional illustrative representations that may be appropriate for inclusion in the management representation letter
 - A new appendix on sources of GAAP
-

SSARS 16, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (issued 12/07)

This statement is eligible to be tested beginning in the July-August 2008 exam window. Only the new statement will be testable starting with the July-August 2008 exam window.

This statement was effective upon issuance.

SSARS 16 defines the levels of responsibility that accountants have in compilation and review engagements in a fashion similar to SAS 102, *Defining Professional Requirements in Statements on Auditing Standards*. The same two categories are used: *unconditional requirements* and *presumptively mandatory requirements*. The definitions of these terms (as well as the rest of the wording) are virtually the same except the SSARS substitutes "accountant" for "auditor" and of course, SSARS references replace SAS references.

SQCS 7, *A Firm's System of Quality Control* (issued 10/07)

This statement is eligible to be tested beginning in the July-August 2008 exam window. Both the previous and the new statement may be tested in the July-August and the October-November 2008 exam windows. Only the new statement will be testable starting with the January-February 2009 exam window.

This statement supersedes **all** existing SQCSs. This statement is effective as of January 1, 2009. Early application is permitted.

As both SQCS 7 and the existing standards (SQCS 2 through 6) will be testable until the January-February 2009 exam window, the section of the 37th edition of the text that covers Quality Control Standards (Chapter 1, IV) is presented below with italicized notations added for only the pertinent changes, clarifications, and additions contained in SQCS 7.

Quality Control Standards

A. Relationship of GAAS & Quality Control Standards

GAAS relates to the conduct of individual audit engagements. Statements on Quality Control Standards (SQCS) relate to the conduct of a CPA firm's audit practice as a whole. A firm's audit practice is composed of individual audit engagements, thus GAAS and quality control standards are related, and the latter may affect the conduct of individual audit engagements as well as a firm's audit practice as a whole. SQCS 6 clarifies that deficiencies in individual audit, attest, compilation, and review engagements do not, in and of themselves, indicate that a firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards. SAS 98 clarifies that although an effective quality control system is conducive to compliance with GAAS, deficiencies in or noncompliance with a firm's quality control system do not, in and of themselves, indicate that an engagement was not performed in accordance with the applicable professional standards.

1. **Standards** Individual CPAs and firms of CPAs must comply with GAAS in the conduct of their audit practice. Firms should establish quality control policies and procedures that provide reasonable assurance of conforming with GAAS in the conduct of their audit engagements.

2. **Quality Control** The nature and extent of the quality control policies and procedures depend on such factors as a firm's size, the degree of operating autonomy that its personnel and its practice offices are allowed, the nature of its practice, its organization, and appropriate cost-benefit considerations.

B. System of Quality Control (SQCS 2, 4)

SQCS 2 applies to quality control for all auditing, accounting, review, compilation, and agreed-upon procedure services for which professional standards have been established. It does not prescribe provisions for other areas of a firm's practice, such as tax services and management consulting services except to the extent they are part of applicable services. Firms that are members of the AICPA Division for CPA Firms must adhere to quality control standards promulgated by the Institute. All members of the AICPA may be called upon to justify departures.

1. Definitions

- a. **Objective** The reason for having a system of quality control is to give a firm reasonable assurance that it is meeting its responsibility to provide professional services that conform with professional standards.

SQCS 7: "The 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."

- b. **Firm** "A proprietorship, partnership, or professional corporation or association engaged in the practice of public accounting, including individual partners or shareholders thereof."

SQCS 7: "A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the American Institute of Certified Public Accountants that is engaged in the practice of public accounting."

- c. **Professional Standards** Relate to the professional qualities and performance of individual members of the AICPA. These include AICPA Rules of Conduct, Auditing Standards Board Pronouncements, and pronouncements of the Accounting and Review Services Committee.

SQCS 7: "Standards established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rules 201 or 202 of the AICPA Code of Professional Conduct or other standard setting bodies that set auditing and attest standards applicable to the engagement being performed."

- d. **Personnel** Unless stated otherwise, *personnel* includes all of a firm's professionals who perform auditing and accounting and review services. This includes proprietors, partners, principals, and stockholders or officers of professional corporations, and their professional employees.

SQCS 7: "All individuals who perform professional services for which the firm is responsible, whether or not they are CPAs."

- e. **System of Quality Control** A system of quality control includes the organizational structure of a firm and the policies adopted and procedures established to provide reasonable assurance that a firm is meeting its responsibility to provide professional services that conform with professional standards. Because the organizational structure, policies, and nature of practice will vary from firm to firm, the system should be appropriately comprehensive and designed suitably (i.e., each firm will not have the same system of quality control).

- (1) **Limitations** There are inherent limitations in any system of quality control that can reduce its effectiveness (for example, variance in individual performance and understanding of professional requirements).
- (2) **Foreign Offices** A U.S. firm should have a system of quality control that provides reasonable assurance that work performed by its foreign offices or by its domestic or foreign affiliates or correspondents meets U.S. professional standards.
- f. **Responsibilities** Responsibilities for the quality control system design and maintenance should be assigned to personnel as needed to implement the quality control policies and procedures effectively. All firm personnel are responsible for compliance with the policies and procedures.
- g. **Communication** The quality control policies and procedures should be communicated to personnel in a way that will provide reasonable assurance that they will understand the policies and procedures.

SCQS 7: The new standard states that although communication is enhanced if in writing, it is not required. In addition to the policies and procedures of the quality control system, the objectives they are designed to achieve should also be communicated. Feedback from personnel should be encouraged.

- h. **Documentation** While having written policies and procedures usually enhances the communication, it is not necessarily true that the effectiveness of a firm's system of quality control will be harmed if it is not written. Factors such as the size, structure, and nature of practice of a firm are determining factors in assessing the need to document and, if it is required, the extent of documentation. Usually, it would be expected that a large firm would have more documentation than a small firm and that a multi-office firm's documentation would be more extensive than a single-office firm.

SQCS 7: Quality control policies and procedures should be documented. The extent of the documentation depends on the size, structure and nature of the firm's practice.

SQCS 7 adds the following definitions of terms:

- i. **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 established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rules 201 or 202 of the AICPA Code of Professional Conduct (ET sections 201-202). Although standards for other engagements may be established by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice."
- j. **Engagement Documentation** "The record of work performed, results obtained, and conclusions the practitioner reached, also known as working papers or workpapers."
- k. **Engagement Partner** "An individual responsible for supervising engagements covered by this section and signing or authorizing an individual to sign the report on such engagements, and who, where required, has the appropriate authority from a professional, legal or regulatory body. Firms may use different titles to refer to individuals with this authority."
- l. **Engagement Quality Control Review** "A process designed to provide an objective evaluation, by an individual or individuals who are not members of the engagement team, of the significant judgments the engagement team made and the conclusions they reached in formulating the report."

- m. Engagement Quality Control Review** “A partner, other person in the firm, qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to perform the engagement quality control review.”
- n. Engagement Team** “All personnel performing the engagement, excluding those who perform the engagement quality control review. The engagement team (i) includes all employees and contractors retained by the firm who perform engagement procedures, irrespective of their functional classification (for example, audit, tax, or management consulting services) and (ii) excludes specialists as discussed in AU section 336, *Using the Work of a Specialist*, and individuals who perform only routine clerical functions, such as word processing and photocopying.”
- o. 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 is an element of monitoring.”
- p. Monitoring** “A process comprising an ongoing consideration and evaluation of the firm’s system of quality control, the objective of which is to enable the firm to obtain reasonable assurance that its system of quality control is designed appropriately and operating effectively.”
- q. Partner** “An 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.”
- r. Professional Requirements** The SQCS uses two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on firms—“unconditional requirements” and “presumptively mandatory requirements”—which are defined in a fashion similar to the same terms in SAS 102.
- s. Qualified External Person** “An individual outside the firm with the capabilities and competence to act as an engagement partner.”
- t. Reasonable Assurance** “In the context of this standard, a high, but not absolute, level of assurance.”
- u. 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 state boards of accountancy and applicable regulatory agencies, which may be more restrictive.”
- v. Staff** “Personnel, other than partners and engagement partners, including any specialists who are employees of the firm.”

2. **Elements of Quality Control** Each of the following interrelated elements should be included in quality control policies and procedures:

Quality Control Mnemonic

I	Independence, integrity & objectivity
M	Monitoring
A	Acceptance & continuance of clients
P	Personnel management
E	Engagement performance
I'M APE Over Quality Control!	

SQCS 7:

Quality Control System Elements

Leadership responsibilities for quality within the firm (the "tone at the top")	
I	Independence, integrity & objectivity Relevant ethical requirements
M	Monitoring
A	Acceptance & continuance of clients relationships & specific engagements
P	Personnel management Human resources
E	Engagement performance

- a. **Independence, Integrity & Objectivity** Policies and procedures should be established to provide reasonable assurance that personnel maintain independence (in fact and appearance) as required, discharge all professional responsibilities with integrity, and maintain objectivity in performing professional responsibilities.

SQCS 7:

Relevant Ethical Considerations Policies and procedures should be designed to obtain reasonable assurance that the firm and its personnel comply with relevant ethical requirements. The AICPA Code of Professional Conduct establishes these fundamental principles of professional ethics: responsibilities; the public interest; integrity; objectivity and independence; due care; and scope and nature of services.

The SQCS also refers CPA firms to the AICPA's Conceptual Framework for AICPA Independence Standards for guidance. The objectives of a firm's policies and procedures on independence should be:

- Communication of the firm's independence requirements to its personnel and, as needed, to others
- The identification and evaluation of circumstances and relationships that put independence at risk and the elimination of those risks with safeguards, if possible, and if not, withdrawal from the engagement

The firm's policies and procedures on independence and objectivity and should be designed to ensure that:

- it is notified of any breaches of independence
- any regulatory requirements for rotation of personnel are met

At least annually, a firm should obtain written confirmation of compliance with its policies and procedures on independence from all personnel.

- b. Personnel Management** Personnel management includes hiring, assigning personnel to engagements, professional development, and advancement decisions. The efficiency of the quality control system depends on the characteristics of personnel that perform, supervise, and review work. Usually, less direct supervision is needed when personnel assigned to a specific engagement are more able and more experienced.

SQCS 7:

Human Resources *The SQCS frames the human resources policies and procedures description with the need to have personnel who can meet the previously stated objectives of a system of quality control.*

Quality Control: Personnel Management Mnemonic

H	Hiring
E	Assignment of personnel to engagements
A	Advancement
D	Professional development

SQCS 7:

Quality Control: Human Resources Facets

H	<i>Recruitment and Hiring</i> <i>Determining capabilities and competencies</i>
E	Assignment of personnel to engagements
A	<i>Performance evaluation, compensation, and advancement</i>
D	Professional development

- (1) Hiring** Policies and procedures for hiring should be established to provide reasonable assurance that those persons hired possess the appropriate characteristics to enable them to perform their work competently.

SQCS 7:

Recruitment and Hiring: *Effective recruitment also includes the ability to select individuals of integrity who have the capacity for further development.*

- (2) Assignment of Personnel to Engagements** Policies and procedures for assigning personnel to engagements should be established to provide reasonable assurance that the work will be performed by those who possess the appropriate degree of technical training and proficiency. It is important to consider the nature and extent of supervision that will be required. As a general rule, the need for supervision decreases as more able and experienced personnel are assigned to the engagement.

SQCS 7: *The firm should establish policies and procedures that require that the responsibilities of the engagement partner are clearly defined and communicated to that person and likewise, that the identity and role of the engagement partner are communicated to the client's management and those charged with governance.*

The SQCS includes a recommendation that systems be established to monitor the workload and availability of engagement partners to ensure that they have time to adequately perform their assignments.

Factors to consider when assigning the appropriate staff are very similar to the competency requirements for a practitioner-in-charge (in the existing standards). See section C. Practitioner-in-Charge, 4. Scope of this outline. Teamwork and training for less experienced members is important.

- (3) **Professional Development** Policies and procedures for professional development should be established to provide reasonable assurance that the personnel will have the knowledge that is required to fulfill those responsibilities assigned and to progress within a firm.

SQCS 7: *The importance of passing the CPA exam should be stressed.*

- (4) **Advancement** Policies and procedures for advancing personnel should be established to provide reasonable assurance that those advanced within a firm will be qualified to perform their new responsibilities and that those meeting stated criteria are assigned increased degrees of responsibilities. Qualifications that personnel selected for advancement should possess include character, motivation, intelligence, and judgment.

SQCS 7:

Performance Evaluation, Compensation, and Advancement *Recognition and reward should be given to personnel who demonstrate a commitment to ethical principles as well to professional development and maintenance of competence.*

The size and circumstances of the firm have a bearing on the degree of formality used to evaluate personnel.

SQCS 7 adds the following facet to the element of human resources:

- (5) **Determining capabilities and competencies** *The material concerning this facet is essentially the same that is contained in SQCS 5, "The Personal Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement," which is covered in section C. Practitioner-in-Charge of this outline. SQCS 7 expands some of the general concepts to apply them to other personnel as well.*

- c. **Acceptance & Continuance of Clients & Engagements** Policies and procedures should be established for making the decision as to whether to accept or continue a client (to minimize the chance of being associated with a client whose management lacks integrity). For example, the auditor should inquire of third parties (i.e., bankers and attorneys) about the prospective clients. SQCS 2 requires policies to ensure obtaining an (oral or written) understanding with the client concerning the nature, scope, and limitations of provided services. Quality control policies also should ensure that a firm appropriately considers the risks associated with providing services in the specific engagement and undertakes only engagements that a firm can reasonably expect to complete with professional competence.

SQCS 7:

The resolution of significant issues that arise should be documented.

Factors to consider regarding client integrity include the:

- *Nature of the client's operations, including its business practices*
- *Attitude of the client's management and those charged with governance about internal control or such matters as the aggressive interpretation of accounting standards*

- d. **Engagement Performance** Engagement performance includes all steps of the design and performance of an engagement. Policies should provide reasonable assurance that work meets applicable professional standards, regulatory requirements, and a firm's standards of quality plus that personnel consult appropriate authoritative literature or other sources as needed. SQCS 4 requires QC policies and procedures to address, where applicable, the concurring partner review requirements applicable to SEC engagements required by membership in the SEC Practice Section of the AICPA.

SQCS 7: *Policies and procedures should also provide reasonable assurance that the firm or engagement partners issue appropriate reports.*

Policies and procedures should address engagement performance, supervision responsibilities, and review responsibilities.

Policies and procedures should be established to ensure the confidentiality, safe custody, integrity, accessibility, retention, and retrievability of engagement documentation.

Consultation policies and procedures should ensure that:

- *Consultation takes place when appropriate*
- *Sufficient resources are available to enable it to take place*
- *All relevant facts are provided to those consulted*
- *The conclusions reached should be documented and implemented*

A firm should have policies and procedures in place for resolving differences of opinion within the engagement team and between the team and others, including the engagement quality control reviewer. The report should not be released until all issues are resolved. The conclusions should be documented and implemented.

Criteria should be developed to determine when an engagement quality control review should be performed. The review should be completed before the report is released. Accordingly, the review should be conducted in a timely manner and may be done at appropriate stages during the engagement. The involvement of the quality control reviewer does not result in the transfer of any responsibility for the engagement from the engagement partner. The extent of the review may depend, among other things, on the complexity of the engagement and the degree of risk that the report may not be appropriate. The review should include:

- *An evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report; this should include a selection of related engagement documentation for review*
- *The reading of the financial statements or other subject matter information to determine if the report is appropriate*
- *A discussion with the engagement partner regarding significant findings and issues*

Even though the engagement quality control reviewer is not a member of the engagement team, the reviewer should also satisfy the independence requirements relating to the engagements reviewed. Additionally, when there are enough partners in a firm to make it practicable, the reviewer should not be selected by the engagement partner.

Consultation during the engagement with the quality control reviewer by the engagement team to assure the acceptability of a judgment or concerning other matters does not necessarily impair the quality control reviewer's objectivity. However, should the nature and extent of such consultations become significant; both parties need to exercise caution to preserve the reviewer's objectivity. The reviewer should be replaced by the firm if impairment does occur.

There should be documentation that the:

- *Firm's engagement quality control review procedures have been followed*
- *Review was completed before the report was released*
- *Reviewer is not aware of any significant unresolved matters*

- e. Monitoring** *Monitoring is an ongoing evaluation of each of the other elements of quality control to ensure that they are designed and applied effectively.*

SQCS 7:

- *Monitoring procedures should be designed to enable the firm to assess compliance with all applicable professional standards and regulatory requirements, and the firm's quality control policies and procedures.*
- *Firms are required to assign responsibility for monitoring to a person of appropriate authority and experience and assign performance of monitoring to qualified personnel. They are required to evaluate deficiencies and communicate recommendations for remedial action.*
- *Policies and procedures should be established for dealing with complaints and allegations of noncompliance with professional standards or with the firm's system of quality control. There should be clearly defined channels for personnel to use to communicate concerns without fear of reprisal. Complaints and allegations and the responses to them should be documented.*

SQCS 7 adds this element to a quality control system:

f. Leadership Responsibilities *A firm's quality control policies and procedures should require that a firm's leadership assume ultimate responsibility for the quality control system. The policies and procedures should support a culture within the firm that recognizes that quality is essential and this should be reflected in the firm's business strategy. Accordingly, these policies should be established:*

- (1) Management responsibilities should be assigned so that commercial considerations do not override the quality of work performed.*
- (2) Performance evaluations, compensation (including incentives), and advancement of personnel should be geared to demonstrate the firm's commitment to the objectives of the quality control system.*
- (3) Sufficient and appropriate resources should be devoted to the development, communication, and support of its quality control procedures*

Additionally, the person(s) assigned operational responsibility for quality control should be qualified and given the necessary authority.

- 3. Documentation of Compliance With Quality Control Policies & Procedures** *Documentation concerning compliance with quality control policies and procedures should be retained for a sufficient period of time for monitoring and peer reviews. The form and content of documentation is a matter of judgment and depends on several factors.*

SQCS 7: *Documentation of the operation of quality control policies and procedures should be sufficient to provide evidence of the operation of each element of the quality control system. The retention period may be longer than that needed for monitoring and peer review activities if required by law or regulation.*

C. Practitioner-in-Charge (SQCS 5)

SQCS 5 expands on the policies and procedures related to personnel management discussed in SQCS 2. SQCS 5 requires policies to be adequate to provide a firm with reasonable assurance that a practitioner-in-charge (PIC) possesses the competencies appropriate to the circumstances of particular engagements, i.e., those competencies necessary to fulfill a PIC's engagement responsibilities. When establishing policies and procedures related to the competencies of the PIC, a firm may need to consider other quality control policies and procedures.

Editor's note: *SQCS 5 has been incorporated into SQCS 7—mainly in the section on the human resources element of a system of quality control concerning policies and procedures related to an engagement partner.*

1. **Practitioner-in-Charge** A PIC of an attest engagement is the individual signing (or authorizing another to sign) the accountant's report in connection with accounting, auditing, and attestation engagements. A PIC is responsible for supervising these engagements.

SQCS7: *The term "practitioner-in-charge" is not used in SQCS 7. See the definitions section of this updating supplement for the definition of "engagement partner"; it is very similar to the definition of a PIC above.*

2. **Competencies** Competencies are knowledge, skills, and abilities that enable a PIC to perform engagements. A firm must determine necessary competencies for particular engagements. Competencies are measured in qualitative, rather than quantitative, terms. Ordinarily, a PIC obtains required competencies through experience in public accounting practice. Relevant industry, governmental, and academic experience also may provide a PIC with competencies. A PIC may supplement experience with CPE and consultation.
3. **Extent** The nature and extent of competencies required for a particular engagement are dependent on the attributes of an individual client, industry, and type of service. For instance, different competencies are necessary for the following services: compiling versus reviewing or auditing financial statements; financial service entities, governmental entities, employer benefit plan entities versus entities in other industries; public versus nonpublic companies; an engagement to examine management's assertion about the effectiveness of an entity's internal control over financial reporting versus an engagement to examine investment performance statistics.
4. **Scope** While necessary competencies are broad in scope and varied in nature, they ordinarily include: understanding of quality control and the code of professional conduct; understanding of the service to be performed; technical proficiency; familiarity with the industry; professional judgment; and understanding the entity's information technology systems. Obtaining one competency may be related to gaining another, as competencies are interrelated.
5. **Uniform Accountancy Act** A firm's compliance with SQCS 5 is intended to meet and exceed the requirements of the Uniform Accountancy Act (UAA). CPAs are required to meet the legal requirements of the applicable licensing jurisdiction governing public accounting, which may incorporate parts of the UAA.

D. Monitoring (SQCS 3)

When monitoring quality control, the effects of a firm's management philosophy and the environment in which a firm and its clients operate should be considered. Monitoring involves an ongoing consideration of the: (1) relevance and adequacy of the policies and procedures, (2) appropriateness of guidance materials and practice aids, (3) effectiveness of professional development activities, and (4) compliance with the policies and procedures.

Editor's Note: *SQCS 3 has been incorporated into SQCS 7—mainly in the section on the monitoring element of a system of quality control.*

SQCS 7: *The purpose of monitoring procedures is to provide a comprehensive evaluation of adherence to all applicable professional standards and regulatory and legal requirements and the firm's quality control policies and procedures; and whether the quality control system has been appropriately designed and effectively implemented so that appropriate reports are issued.*

1. **Inspection Procedures** Inspection procedures include the evaluation of the adequacy of, personnel's comprehension of, and compliance with a firm's QC policies and procedures. The extent, nature and need for inspection procedures depends on the existence and effectiveness of the other monitoring procedures. Inspection procedures include:
 - a. Review of engagement workpapers, reports, and clients' financial statements
 - b. Annual summaries of findings from inspection processes and consideration of systemic causes of findings
 - c. Determination of corrective actions or improvements for the specific engagements involved

- d. Communication of findings to appropriate firm management
- e. Timely consideration of findings by appropriate firm management

SQCS 7: *Some of the monitoring procedures above and others listed in the standard can be accomplished via engagement quality reviews and postissuance reviews of engagement working papers, reports, and clients' financial statements for selected engagements, as well as inspection procedures.*

- 2. Preissuance or Postissuance Review of Selected Engagements** Personnel performing or supervising a review to be used as an inspection procedure should not be associated directly with the engagement performance. Sufficiently comprehensive preissuance or postissuance review procedures may constitute inspection procedures if findings indicating the need for improvement or modification are summarized and communicated to management personnel responsible for monitoring the QC system. The management personnel must consider any systemic cause of these findings on a timely basis and implement, communicate, and monitor appropriate changes. Preissuance, and except for the circumstance described below for small firms, a postissuance review of engagements by the person with final responsibility for the engagement does **not** constitute a monitoring procedure.

SQCS 7: *The standard omits any mention of "preissuance" reviews.*

- 3. Evaluation** Analysis and evaluation of new pronouncements, results of independence confirmations, professional development activities, acceptance/continuance decisions, and personnel interview. Determination of improvements and corrections to be made to the system.
- 4. Communication** Communication of any weakness in, lack of understanding of, or compliance with the quality control system to the appropriate management personnel.

SQCS 7: *At least annually, the firm should communicate the results of the monitoring of its quality control process to relevant engagement partners and other personnel, including the firm's leadership. The communication should be thorough enough to enable the firm to take prompt corrective action and provide a basis for their reliance on the system of quality control. The information should include:*

- *A description of the monitoring procedures performed*
 - *The conclusions drawn from the monitoring procedures*
 - *A description of any systemic, repetitive, or other significant deficiencies and of the corrective actions taken*
- 5. Follow-Up** Timely modifications by appropriate personnel.
- 6. Small Firms** In firms with a limited number of management-level personnel, monitoring procedures may need to be performed by people who are responsible for compliance with QC procedures. Postissuance review of engagements by the person with final responsibility for the engagement may constitute a monitoring procedure in small firms. Small firms may prefer to engage a qualified outside individual to perform inspection procedures.
- 7. Peer Review** A peer review does **not** substitute for *monitoring* procedures. However, a firm's QC policies and procedures may provide that a peer review may substitute for some of its inspection procedures for the applicable period.

SQCS 7:

- 8. Documentation** *Policies and procedures should be established to document:*

- *Monitoring procedures, including the selection method of completed engagements to be inspected*
- *A record of the evaluation of*

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether as a result of the foregoing, that appropriate reports are issued
- Identification and evaluation of the deficiencies and the basis for determining if further action was needed

SSARS 17, Omnibus Statement on Standards for Accounting and Review Services—2008 (issued 2/08)

This statement is eligible to be tested beginning in the October-November 2008 exam window. Both the previous and the new guidance are testable in the October-November 2008 exam window. Only the new guidance will be testable starting with the January-February 2009 exam window.

This statement was effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008. Early application was permitted.

The term *nonpublic entity* was replaced with *nonissuer* in sections 100, 200, and 300. The statement adds definitions for issuer and nonissuer:

- Issuer: “An issuer is 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.”

The Securities Exchange Act of 1934 states: “**The term ‘issuer’ means any person who issues or proposes to issue any security;** except that with respect to certificates of deposit for securities, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term ‘**issuer**’ means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except that with respect to equipment-trust certificates or like securities, the term ‘**issuer**’ means the person by whom the equipment or property is, or is to be, used.”

- Nonissuer: “All entities except for those defined as issuers.”

Generally, a *nonpublic entity* as it was previously defined by the SSARS, would be considered a nonissuer per these definitions.

Other terms’ definitions were also revised or added:

- Those charged with governance (added): “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). In some entities, governance is a collective responsibility that may be carried out by a board of directors, a committee of the board of directors, a committee of management, partners, equivalent persons, or some combination thereof. Those charged with governance are specifically excluded from management, unless they perform management functions as defined below.”
- Management (added): “The person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.”
- Third party (revised): “All persons, including those charged with governance, except for those members of management as defined above.”

- Compilation of financial statements (revised): “A service, the objective of which is to present in the form of financial statements, information that is the representation of management (owners) without undertaking to express any assurance on the financial statements.” To further emphasize that no assurance is provided, a new section, “Objective of a Compilation Engagement,” reiterates this.
- Review of financial statements (revised): “A service, the objective of which is to express limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with GAAP.” This objective of a review is reiterated in a new section, “Objective of a Review Engagement.”

A new section, “Review Performance Requirements” (AR §100.29) revises AR §100.26 to state that the accountant must:

- “apply analytical procedures to the financial statements...”
- “make inquiries of management and, when deemed appropriate, other company personnel...”
- “obtain representations from management for all financial statements and periods covered by the accountant’s review report...”

The sections on analytical procedures and management representations for a review engagement were revised to be consistent with this new section on performance requirements. Also, guidance is changed regarding the date of the management representation letter—rather than “as of a date no earlier than the date of the accountant’s report”; the letter should be dated “as of the date of the accountant’s report.”

Guidance for the consideration of an entity’s ability to continue as a going concern for an accountant performing compilation or review procedures has been added in AR §100.69 - 100.72 as follows.

- Evidence may come to the accountant’s attention that suggests there is an uncertainty about the entity’s ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being compiled or reviewed. If so, the accountant should request that management determine the possible effects of this uncertainty on the financial statements, included needed disclosures.
- The accountant should consider if management’s conclusions about these possible effects on the financial statements are reasonable and if any related disclosures are adequate. If they are not, the accountant should follow the guidance for departures from GAAP included in the statement.
- If the uncertainty about the entity’s ability to continue as a going concern is disclosed in the financial statements, the accountant may emphasize the matter in the report.

Guidance for the consideration of subsequent events for an accountant performing compilation or review procedures has been added in AR §100.73 - 100.76 as follows.

- These are events or transactions that occur subsequent to the balance sheet date, but prior to managements’ issuance of the financial statements that have a material effect on the financial statements.
- Whether they are discovered by the accountant during the performance of procedures or subsequent to the date of the accountant’s report, but prior to its release, the accountant should request that management consider the possible effects on the financial statements and the adequacy of any related disclosures. If they are not, the accountant should follow the guidance for departures from GAAP included in the statement.
- If the subsequent event is disclosed in the financial statements, the accountant may emphasize the matter in the report.

ERRATA

The following items are in the textbook only, unless otherwise noted. If you find other items that you believe are ambiguous or in error, please contact the Bisk Education editors (help@cpaexam.com) with details.

Chapter 22: Page 22-38, the second line of the title of the second statement presented on this page should be "Consolidated Statements of Cash Flows"; not "Consolidated Income Statements."

Page 22-47, the quotation included in the explanation to multiple choice question 28 (ID 4260) is from SAS 110; not SAS 109.

Page 22-56, the paragraph reference answer for the research portion of simulation 22-6 should be AU 312.54. Guidance: AU 312.54 states, "When the auditor tests relevant assertions related to an account balance or a class of transactions by a substantive analytical procedure, the auditor might not specifically identify misstatements but would obtain only an indication of whether misstatement might exist in the balance or class and possibly its approximate magnitude. If the substantive analytical procedure indicates that a misstatement might exist, but not its approximate amount, the auditor should request management to investigate and, if necessary, should expand his or her audit procedures to enable him or her to determine whether a misstatement exists in the account balance or class of transactions."

Chapter 25: Page 25-56, answer explanations to multiple choice questions 4 through 10 are not labeled with the correct question numbers:

- For question 4's answer explanation, see answer explanation 5.
- For question 5's answer explanation, see answer explanation 6.
- For question 6's answer explanation, see answer explanation 7.
- For question 7's answer explanation, see answer explanation 8.
- For question 8's answer explanation, see answer explanation 9.
- For question 9's answer explanation, see answer explanation 10.
- For question 10's answer explanation, see answer explanation 4.

Chapter 26: Page 26-20, the explanation for Example (not Exhibit) 9 should state that the tolerable rate has been determined to be 3% instead of "Remember that our tolerable rate is 3%."