

## AUDITING &amp; ATTESTATION

CPA2902US1-39

## TABLE OF CONTENTS

About Updating Supplement Version 39.1 .....	2
Study Options Available to Candidates .....	2
Other Sources of Information for Candidates .....	2
Important Announcement (CBT-e); <b>effective January-February 2011</b> .....	3
Recent Pronouncements .....	5
PCAOB AS 7, <i>Engagement Quality Review</i> ; <b>testable July-August 2010</b> .....	5
SAS 117 (AU 801), <i>Compliance Audits</i> ; <b>testable July-August 2010</b> .....	5
SSARS 19, <i>Compilation and Review Engagements</i> , paragraph 2.21 (AR 80, <i>Compilation of Financial Statements</i> , paragraph 21)—allowing the disclosure of the reasons for an independence impairment in a compilation report; <b>testable July-August 2010</b> .....	18
SAS 118 (AU 550), <i>Other Information in Documents Containing Audited Financial Statements</i> ; <b>testable October-November 2010</b> .....	18
SAS 119 (AU 551), <i>Supplementary Information in Relation to the Financial Statements as a Whole</i> ; <b>testable October-November 2010</b> .....	22
SAS 120 (AU 558), <i>Required Supplementary Information</i> ; <b>testable October-November 2010</b> .....	26
SSAE 16 (AT 801), <i>Reporting on Controls at a Service Organization</i> ; <b>testable January-February 2011</b> .....	31
Errata .....	33
Recently Released AICPA Questions and Answers .....	34

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### ABOUT UPDATING SUPPLEMENT VERSION 39.1

This supplement is designed to bring the very latest information to candidates using our products in preparation for the CPA exam in the July-August 2010 and later exam windows. Candidates using our 39<sup>th</sup> edition textbook or the corresponding version 13 series software will find the information in updating supplement version 39.1 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!***

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### 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 using our 37<sup>th</sup> and earlier editions are strongly encouraged to purchase new materials. Please contact a customer service representative at 1-800-280-9718.

Candidates using our 38<sup>th</sup> edition of the textbook or corresponding version 12 series software will also need AUD Updating Supplement Version 38.3. AUD Updating Supplement Version 38.3 contains summaries of SAS Nos. 115 (AU 325) and 116 (AU 722); SSAE 15 (AT 501); SSARS 18 (AR 100); and PCAOB AS Nos. 6 and 7. (This content is incorporated into the 39<sup>th</sup> edition.)

## IMPORTANT ANNOUNCEMENT

**The following information is applicable to the January-February 2011 and later exam windows.**

**CBT-e: New Release of the Uniform CPA Examination**

CBT-e is the name the AICPA's Board of Examiners have given to a series of changes that will result in a new release of the Uniform CPA Examination. (CBT stands for Computer-Based Testing and the "e" is for evolution.)

The changes are pervasive, affecting the exam's structure, content, and format. New tutorials and sample tests will be made available by the AICPA on their exam Web site ([www.cpa-exam.org](http://www.cpa-exam.org)) prior to January 2011. (They were not available at the time of this publication, but the AICPA expects to make them available in "early Fall of 2010.") Please visit their Web site (see the CBT-e page) to review these and obtain additional and updated information about the changes. The information presented here is only intended to give candidates an overall idea of the new release of the exam.

The major changes which will be effective January 1, 2011, include:

- **New Uniform CPA Examination Content and Skill Specification Outlines (CSOs/SSOs)**

Much is different in the new CSOs/SSOs. There is additional content and some content has been transferred between exam sections. There are also changes to the organization of the outlines and the scope of the knowledge and skills to be tested.

Examples of the changes include: International Financial Reporting Standards and International Standards on Auditing have been added to the content eligible to be tested; the testing of professional responsibilities (including ethics and independence) have been expanded to include knowledge of codes promulgated by additional organizations and, with the exception of ethics and responsibilities in tax practice, has been transferred from REG to AUD.

The new CSOs/SSOs are available now on the AICPA's exam Web site ([www.cpa-exam.org](http://www.cpa-exam.org)).
- **Written communication tasks added to BEC and removed from all other exam sections**

BEC will have 3 written communication tasks and will be the only exam section to have this type of task. BEC will also have fewer multiple-choice questions (3 testlets, each with 24 questions, for a total of 72 instead of 90 questions). BEC will continue not to have simulations (it currently has only multiple-choice questions).
- **Short task-based simulations (TBS) replace simulations in the current (long) format in AUD, FAR, and REG**

There will be 1 testlet of TBS in each of these exam sections. This means that candidates will be able to view the simulations all at once and respond to them in any order. The TBS testlets in AUD and FAR will contain 7 simulations and the TBS testlet in REG will contain 6. At least one of these simulations will be a research question. The new simulations will be similar to the sections of the current "long" simulations.
- **Testing time for BEC *increased* by a half hour (to 3 hours) and testing time for AUD *decreased* by a half hour (to 4 hours)—total time for all 4 exam sections remains at 14 hours**

These are the only 2 exam sections affected by the change in time allocation (FAR will remain at 4 hours and REG at 3 hours.) This *may* result in an adjustment (redistribution) of fees for BEC and AUD.
- **Scoring weights (value attributed to each item type—multiple-choice questions, TBS, and written communication tasks—in the total score) change in all exam sections**

In AUD, FAR, and REG, multiple-choice questions will account for 60% and TBS for 40% of the total score; in BEC, multiple-choice questions will account for 85% and written communication tasks for 15% of the total score.
- **New release of authoritative literature and a new research task format**

The new release of authoritative literature will include the codified FASB Accounting Standards. How candidates view the authoritative literature and how they enter their responses will change.

The following tables show the changes that will be implemented on January 1, 2011 in the exam section structure, testing time allocations, and scoring weights.

## Uniform CPA Examination Section Structure and Time Allocations—January 2011

**Auditing and Attestation (AUD)**

<b>Current Structure</b>	<b>CBT-e Structure</b>
<ul style="list-style-type: none"> <li>3 multiple-choice question testlets containing a total of 90 questions</li> <li>2 simulations in current (long) format</li> <li>2 written communication tasks</li> </ul>	<ul style="list-style-type: none"> <li>3 multiple-choice question testlets containing a total of 90 questions</li> <li>1 testlet containing 7 short task-based simulations with the research question in a new format</li> </ul>
<b>Current testing time: 4.5 hours</b>	<b>CBT-e testing time: 4 hours</b>

**Business Environment and Concepts (BEC)**

<b>Current Structure</b>	<b>CBT-e Structure</b>
<ul style="list-style-type: none"> <li>3 multiple-choice question testlets containing a total of 90 questions</li> </ul>	<ul style="list-style-type: none"> <li>3 multiple-choice question testlets containing a total of 72 questions</li> <li>3 written communication tasks on BEC topics</li> </ul>
<b>Current testing time: 2.5 hours</b>	<b>CBT-e testing time: 3 hours</b>

**Financial Accounting and Reporting (FAR)**

<b>Current Structure</b>	<b>CBT-e Structure</b>
<ul style="list-style-type: none"> <li>3 multiple-choice question testlets containing a total of 90 questions</li> <li>2 simulations in current (long) format</li> <li>2 written communication tasks</li> </ul>	<ul style="list-style-type: none"> <li>3 multiple-choice question testlets containing a total of 90 questions</li> <li>1 testlet containing 7 short task-based simulations with the research question in a new format</li> </ul>
<b>Current testing time: 4 hours</b>	<b>CBT-e testing time: 4 hours</b>

**Regulation (REG)**

<b>Current Structure</b>	<b>CBT-e Structure</b>
<ul style="list-style-type: none"> <li>3 multiple-choice question testlets containing a total of 72 questions</li> <li>2 simulations in current (long) format</li> <li>2 written communication tasks</li> </ul>	<ul style="list-style-type: none"> <li>3 multiple-choice question testlets containing a total of 72 questions</li> <li>1 testlet containing 6 short task-based simulations with the research question in a new format</li> </ul>
<b>Current testing time: 3 hours</b>	<b>CBT-e testing time: 3 hours</b>

## Uniform CPA Examination Scoring Weights—January 2011

**AUD, FAR & REG**

<b>Item Format</b>	<b>Current Weight</b>	<b>CBT-e Weight</b>
Multiple-choice questions	70%	60%
Simulations	20%	40%
Written communication tasks	10%	N/A

**BEC**

<b>Item Format</b>	<b>Current Weight</b>	<b>CBT-e Weight</b>
Multiple-choice questions	100%	85%
Simulations	N/A	N/A
Written communication tasks	N/A	15%

## RECENT PRONOUNCEMENTS

**PCAOB AS 7, *Engagement Quality Review*; issued 1/2010**

In January 2010, the SEC approved AS 7, *Engagement Quality Review*. It is effective for engagement quality reviews, or EQRs, of audits and interim reviews conducted in accordance with the standards of the PCAOB for fiscal years that began on or after December 15, 2009. The new standard supersedes the concurring partner review requirement. **It is eligible to be tested beginning with the July-August 2010 exam window.**

The 39<sup>th</sup> edition textbook and the text that is included with the online courses and within the corresponding version 13 series of the software cover this new standard in the 8<sup>th</sup> section of Chapter 29. Coverage is also included in the AUD Updating Supplement Version 38.3 (available to download only as a PDF file on our CPA Review Web site: [www.cpaexam.com/support.asp](http://www.cpaexam.com/support.asp)).

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**SAS 117 (AU 801), *Compliance Audits*; issued 12/2009**

**This statement will be eligible to be tested beginning in the July-August 2010 exam window.** It is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Early application is permitted.

In addition to this updating supplement, this new standard is covered in the text that is included with the online courses and within the 13.2 and later versions of the software in Chapter 29. (The 39<sup>th</sup> edition of the textbook was published prior to the release of this new standard. The topic is covered in the 1<sup>st</sup> section of Chapter 29.)

SAS 117 updates AU 801 of the same title and supersedes SAS 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*. It was issued in response to a federal study that indicated needed improvements. The new statement incorporates the risk assessment standards; addresses the application of GAAS to compliance audits, defines terms, and identifies reporting elements.

Governments normally establish audit requirements for entities to undergo an audit of their compliance with applicable compliance requirements. Compliance audits usually are performed in conjunction with a financial statement audit. AU 801 does **not** apply to the financial statement audit component of such engagements.

1. **Applicability** AU 801, *Compliance Audits*, is applicable when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with *both* GAAS and *Government Auditing Standards* and express an opinion on compliance. An example of an engagement to which this section is applicable is an audit performed in accordance with the provisions of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*.
  - a. **Generally Accepted Auditing Standards (GAAS)** AU 801 requires the adaption and application of many of the AU sections (GAAS) to a compliance audit; however, some AU sections generally cannot be adapted because they are not relevant to a compliance audit. For the most part, these include standards in sections 400, 600, 700, and 900. (An appendix to AU 801 lists the specific AU sections/paragraphs that are not applicable. Some of these standards are listed as not applicable because AU 801 provides specific guidance for their subject matter.) Standards in sections 100, 200, 300, and 500 generally can be adapted to the objectives of a compliance audit. This can be done with relative ease for some standards, for example, by simply replacing the word *misstatement* with the word *noncompliance*. Others are more difficult to adapt and apply—AU 801 provides more specific guidance for these sections. That said, an auditor is not required, in planning and performing a compliance audit, to make a literal translation of each procedure that might be performed in a financial statement audit, but rather to obtain sufficient appropriate audit evidence to support the auditor's opinion on compliance.

- b. **Government Auditing Standards** The standards for financial audits under *Government Auditing Standards*, often referred to as generally accepted government auditing standards (GAGAS) or the “Yellow Book”
- c. **Opinion on Compliance Required** A governmental audit requirement that requires an auditor to express an opinion on compliance

AU 801 is **not** applicable when the governmental audit requirement calls for an examination in accordance with Statements on Standards for Attestation Engagements of an entity’s compliance with specified requirements or an examination of an entity’s internal control over compliance. Statement on Standards for Attestation Engagements AT 601, *Compliance Attestation*, is applicable to these engagements. Laws or regulations will not always indicate which standards to follow. In such cases, auditor judgment will be needed to determine, based on the circumstances, the appropriate standards to follow.

Editor note: GAGAS and governmental audit requirements usually contain certain standards and requirements that are supplementary to those in GAAS.

- 2. **Compliance Is Management’s Responsibility** Management is responsible for ensuring that an entity complies with the compliance requirements. This includes identifying the entity’s government programs and understanding the compliance requirements of each program’s administration. Management should establish internal controls to provide reasonable assurance of compliance. Corrective action should be taken when instances of noncompliance are identified by management’s evaluation and monitoring of controls or as the result of an audit finding.
- 3. **Auditor’s Objectives**
  - a. **Sufficient Appropriate Audit Evidence** The auditor should obtain sufficient appropriate audit evidence to form an opinion and report at the level specified in the governmental audit requirement—most specify that the auditor’s opinion be at the program level—on whether the entity complied in all material respects with the applicable compliance requirements.
  - b. **Perform Procedures to Address Audit & Reporting Requirements** The auditor should identify audit and reporting requirements specified in the governmental audit requirement that are supplementary to GAAS and GAGAS, if any, and perform procedures to address those requirements.
- 4. **Definitions** The standard defines the following terms:
  - a. **Applicable Compliance Requirements** Compliance requirements that are subject to the compliance audit.
  - b. **Audit Findings** The matters that are required to be reported by the auditor in accordance with the governmental audit requirement.
  - c. **Audit Risk of Noncompliance** The risk that the auditor expresses an inappropriate audit opinion on the entity’s compliance when material noncompliance exists. Audit risk of noncompliance is a function of the risks of material noncompliance and detection risk of noncompliance.
  - d. **Compliance Audit** A program-specific audit or an organization-wide audit of an entity’s compliance with applicable compliance requirements.
  - e. **Compliance Requirements** Laws, regulations, rules, and provisions of contracts or grant agreements applicable to government programs with which the entity is required to comply.
  - f. **Deficiency in Internal Control Over Compliance** A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis.

- (1) **Deficiency in Design** This exists when a control necessary to meet the control objective is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
- (2) **Deficiency in Operation** This exists when a properly designed control does not operate as designed or the person performing the control does not possess the necessary authority or competence to perform the control effectively.
- g. **Detection Risk of Noncompliance** The risk that the procedures performed by the auditor to reduce audit risk of noncompliance to an acceptably low level will not detect noncompliance that exists and that could be material, either individually or when aggregated with other instances of noncompliance.
- h. **Governmental Audit Requirement** A government requirement established by law, regulation, rule, or provision of contracts or grant agreements requiring that an entity undergo an audit of its compliance with applicable compliance requirements related to one or more government programs that the entity administers. Governmental audit requirements also may set forth specific supplementary requirements of the compliance audit, for example, procedures to be performed by the auditor, documentation requirements, the form of reporting, and continuing professional education requirements with which the auditor is required to comply.
- i. **Government Auditing Standards** Standards and guidance issued by the Comptroller General of the United States, U.S. Government Accountability Office for financial audits, attestation engagements, and performance audits (also known as generally accepted government auditing standards (GAGAS) or the “Yellow Book”).
- j. **Government Program** The means by which governmental entities achieve their objectives. For example, one of the objectives of the U.S. Department of Agriculture is to provide nutrition to individuals in need. Examples of government programs designed to achieve that objective are the Supplemental Nutrition Assistance Program and the National School Lunch Program. Government programs that are relevant to this section are those in which a grantor or pass-through entity provides an award to another entity, usually in the form of a grant, contract, or other agreement. Not all government programs provide cash assistance; sometimes noncash assistance is provided (for example, a loan guarantee, commodities, or property).
- k. **Grantor** A government agency from which funding for the government program originates.
- l. **Known Questioned Costs** Questioned costs specifically identified by the auditor; known questioned costs are a subset of likely questioned costs.
- m. **Likely Questioned Costs** The auditor’s best estimate of total questioned costs, not just the known questioned costs. Likely questioned costs are developed by extrapolating from audit evidence obtained, for example, by projecting known questioned costs identified in an audit sample to the entire population from which the sample was drawn.
- n. **Material Noncompliance** In the absence of a definition of material noncompliance in the governmental audit requirement, a failure to follow compliance requirements or a violation of prohibitions included in the applicable compliance requirements that results in noncompliance that is quantitatively or qualitatively material, either individually or when aggregated with other noncompliance, to the affected government program.
- o. **Material Weakness in Internal Control Over Compliance** A deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis. In this section, a reasonable possibility exists when the likelihood of the event is either reasonably possible or probable as defined as follows:

- **Reasonably Possible** The chance of the future event or events occurring is more than remote but less than likely.
  - **Remote** The chance of the future event or events occurring is slight.
  - **Probable** The future event or events are likely to occur.
- p. **Organization-Wide Audit** An audit of an entity's financial statements and an audit of its compliance with the applicable compliance requirements as they relate to one or more government programs that the entity administers.
- q. **Pass-Through Entity** An entity that receives an award from a grantor or other entity and distributes all or part of it to another entity to administer a government program.
- r. **Program-Specific Audit** An audit of an entity's compliance with applicable compliance requirements as they relate to one government program that the entity administers. The compliance audit portion of a program-specific audit is performed in conjunction with either an audit of the entity's or the program's financial statements.
- s. **Questioned Costs** Costs that are questioned by the auditor due to:
- (1) **Violations** A violation or possible violation of the applicable compliance requirements
  - (2) **Inadequate Documentation** The costs are not supported by adequate documentation
  - (3) **Unreasonableness** The incurred costs appear unreasonable and do not reflect the actions that a prudent person would take in the circumstances.
- t. **Risk of Material Noncompliance** The risk that material noncompliance exists prior to the audit. This consists of two components, described as follows:
- (1) **Inherent Risk of Noncompliance** The susceptibility of a compliance requirement to non-compliance that could be material, either individually or when aggregated with other instances of noncompliance, before consideration of any related controls over compliance.
  - (2) **Control Risk of Noncompliance** The risk that noncompliance with a compliance requirement that could occur and that could be material, either individually or when aggregated with other instances of noncompliance, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control over compliance.
- u. **Significant Deficiency in Internal Control Over Compliance** A deficiency, or a combination of deficiencies, in internal control over compliance that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

## 5. Compliance Audit Requirements

- a. **Adapting & Applying GAAS** When performing a compliance audit, the auditor, using professional judgment, should adapt and apply the AU sections that are relevant and necessary to meet the objectives.
- b. **Materiality Levels** The auditor should establish and apply materiality levels for the compliance audit based on the governmental audit requirement.

Generally, the auditor's consideration of materiality is in relation to the government program taken as a whole. However, the governmental audit requirement may specify a different level of materiality for one or more of the purposes listed below.

The auditor's determination of materiality usually is influenced by the needs of the grantors because the governmental audit requirement usually is established by them and the audit report on compliance is primarily for their use; however, the auditor also considers the needs of users as a group, including grantors.

The auditor's purpose for establishing materiality levels is to:

- Determine the nature and extent of risk assessment procedures.
- Identify and assess the risks of material noncompliance.
- Determine the nature, extent, and timing of further audit procedures.
- Evaluate whether the entity complied with the applicable compliance requirements.
- Report findings of noncompliance and other matters required to be reported by the governmental audit requirement.

**c. Identifying Government Programs & Applicable Compliance Requirements** The auditor should determine which of the entity's government programs and compliance requirements to test, i.e., the *applicable compliance requirements*, in accordance with the governmental audit requirement. Some governmental audit requirements specifically identify the applicable compliance requirements. Other governmental audit requirements provide a framework for the auditor to determine them.

**(1) Sources of Information About Applicable Compliance Requirements**

- (a) *The Compliance Supplement*** Issued by the OMB, and used in OMB Circular A-133 audits, it contains the compliance requirements that typically are applicable to federal government programs, as well as suggested audit procedures when compliance requirements are applicable and have a direct and material effect on the entity's compliance.
- (b) *Program-Specific Audit Guides*** The applicable program-specific audit guide issued by the grantor agency, which contains the compliance requirements pertaining to the government program and suggested audit procedures to test for compliance.

**(2) Procedures to Obtain Additional Information**

- (a)** Reading laws, regulations, rules, and provisions of contracts or grant agreements that pertain to the government program
- (b)** Making inquiries of management and other knowledgeable entity personnel
- (c)** Making inquiries of appropriate individuals outside the entity, such as the office of the federal, state, or local program official or auditor, or other appropriate audit oversight organizations or regulators, about the laws and regulations applicable to entities within their jurisdiction, including statutes and uniform reporting requirements
- (d)** Making inquiries of a third-party specialist, such as an attorney
- (e)** Reading the minutes of meetings of the governing board of the entity being audited
- (f)** Reading audit documentation about the applicable compliance requirements prepared during prior years' audits or other engagements
- (g)** Discussing the applicable compliance requirements with auditors who performed prior years' audits or other engagements

- d. **Risk Assessment Procedures** For each of the government programs and applicable compliance requirements selected for testing, the auditor should perform risk assessment procedures to obtain a sufficient understanding of the applicable compliance requirements and the entity's related internal controls. This understanding establishes a frame of reference within which the auditor plans the compliance audit and exercises professional judgment about assessing risks of material noncompliance and responding to those risks throughout the compliance audit.
- (1) **Management's Response to Other Engagements' Findings** The auditor should inquire of management about whether there are findings and recommendations in reports or other written communications resulting from previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit. The auditor should gain an understanding of management's response to findings and recommendations that could have a material effect on the entity's compliance, for example, taking corrective action. The auditor should use this information to assess risk and determine the nature, extent, and timing of the audit procedures for the compliance audit, including determining the extent to which testing the implementation of any corrective actions is applicable to the audit objectives.
  - (2) **Other Factors That Influence Nature & Extent of Risk Assessment Procedures**
    - (a) The newness and complexity of the applicable compliance requirements
    - (b) The nature of the applicable compliance requirements
    - (c) The services provided by the entity and how they are affected by external factors
    - (d) The level of oversight by the grantor or pass-through entity
  - (3) **Evaluation of Controls** Performing risk assessment procedures to obtain an understanding of the entity's internal control over compliance includes an evaluation of the design of controls and whether the controls have been implemented.
- e. **Assessing the Risks of Material Noncompliance** The auditor should assess the risks of material noncompliance whether due to fraud or error for each applicable compliance requirement.
- (1) **Pervasive Risk** The auditor should consider whether any of those risks are pervasive to the entity's compliance because they may affect the entity's compliance with many compliance requirements. Examples of situations in which there may be a pervasive risk are an entity's history of poor record keeping for its government programs or an entity that is experiencing financial difficulty and for which there is an increased risk that grant funds will be diverted for unauthorized purposes.
  - (2) **Inherent Risk & Control Risk** In assessing the risks of material noncompliance, the auditor may evaluate inherent risk of noncompliance and control risk of noncompliance individually or in combination.
  - (3) **Factors to Consider** Factors the auditor may consider in assessing the risks of material noncompliance are as follows:
    - (a) The complexity of the applicable compliance requirements
    - (b) The susceptibility of the applicable compliance requirements to noncompliance
    - (c) The length of time the entity has been subject to the applicable compliance requirements
    - (d) The auditor's observations about how the entity has complied in prior years
    - (e) The potential effect on the entity of noncompliance.

- (f) The degree of judgment involved in adhering to the compliance requirements
  - (g) The auditor's assessment of the risks of material misstatement in the financial statement audit
- f. Performing Further Audit Procedures in Response to Assessed Risks**
- (1) **Overall Response** If the auditor identifies risks of material noncompliance that are pervasive to the entity's compliance, the auditor should develop an overall response to such risks.
  - (2) **Tests of Details** The auditor should design and perform further audit procedures, including tests of details, to obtain sufficient appropriate audit evidence about the entity's compliance with each of the applicable compliance requirements in response to the assessed risks of material noncompliance. Risk assessment procedures, tests of controls, and analytical procedures *alone* are **not** sufficient to address a risk of material noncompliance.
    - (a) **Areas to Test** Examples of areas where tests of details may be performed include grant disbursements or expenditures; eligibility files; cost allocation plans; and periodic reports filed with grantor agencies.
    - (b) **Intentional and Unintentional Noncompliance** A compliance audit includes designing procedures to detect both intentional and unintentional material noncompliance.
    - (c) **Sampling** An auditor may decide to use audit sampling to obtain sufficient appropriate audit evidence in a compliance audit.
  - (3) **Tests of Operating Effectiveness of Controls** If *any* of the following conditions are met, the auditor should test the operating effectiveness of controls over each applicable compliance requirement to which the conditions apply in each compliance audit. The use of audit evidence about the operating effectiveness of controls obtained in prior audits is **not** applicable to a compliance audit.
    - (a) The auditor's risk assessment includes an expectation of the operating effectiveness of controls over compliance related to the applicable compliance requirements.
    - (b) Substantive procedures alone do not provide sufficient appropriate audit evidence.
    - (c) Such tests of controls over compliance are required by the governmental audit requirement.
- g. Supplementary Audit Requirements** The auditor should determine whether audit requirements are specified in the governmental audit requirement that are supplementary to GAAS and GAGAS and perform procedures to address those requirements, if any.
- h. Written Representations** The auditor should request from management written representations that are tailored to the entity and the governmental audit requirement. In some cases, management may include qualifying language to the effect that representations are made to the best of management's knowledge and belief; however, such qualifying language is not appropriate for the representations in the first, second and last of the following statements:
- (1) Acknowledging management's responsibility for understanding and complying with the compliance requirements;
  - (2) Acknowledging management's responsibility for establishing and maintaining controls that provide reasonable assurance that the entity administers government programs in accordance with the compliance requirements;

- (3) Stating that management has identified and disclosed to the auditor all of its government programs and related activities subject to the governmental audit requirement;
- (4) Stating that management has made available to the auditor all contracts and grant agreements, including amendments, if any, and any other correspondence relevant to the programs and related activities subject to the governmental audit requirement;
- (5) Stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements or stating that there was no such noncompliance;
- (6) Stating whether management believes that the entity has complied with the applicable compliance requirements (except for noncompliance it has disclosed to the auditor);
- (7) Stating that management has made available to the auditor all documentation related to compliance with the applicable compliance requirements;
- (8) Identifying management's interpretation of any applicable compliance requirements that are subject to varying interpretations;
- (9) Stating that management has disclosed to the auditor any communications from grantors and pass-through entities concerning possible noncompliance with the applicable compliance requirements, including communications received from the end of the period covered by the compliance audit to the date of the audit report;
- (10) Stating that management has disclosed to the auditor the findings received and related corrective actions taken for previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit, including findings received and corrective actions taken from the end of the period covered by the compliance audit to the date of the audit report;
- (11) Stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements subsequent to the period covered by the audit report or stating that there were no such known instances; and
- (12) Stating that management is responsible for taking corrective action on audit findings of the compliance audit.

The auditor should request any additional representations needed, if any.

- i. **Subsequent Events** The auditor should perform audit procedures up to the date of the audit report to obtain sufficient appropriate audit evidence that all subsequent events related to the entity's compliance during the period covered by the audit report on compliance have been identified. The nature and extent of these procedures should take the auditor's risk assessment into account.
  - (1) **Procedures** Audit procedures should include, but are not limited to, inquiring of management about and considering:
    - (a) Relevant internal auditors' reports issued during the subsequent period;
    - (b) Other auditors' reports identifying noncompliance that were issued during the subsequent period;
    - (c) Reports from grantors and pass-through entities on the entity's noncompliance that were issued during the subsequent period; and
    - (d) Information about the entity's noncompliance obtained through other professional engagements performed for that entity.

(2) **Period Subsequent to Audit Report** The auditor has no obligation to perform any audit procedures related to the entity's compliance during the period subsequent to the period covered by the audit report. However, if before the report release date, the auditor becomes aware of noncompliance in the period subsequent to the period covered by the audit report that is of such a nature and significance that its disclosure is needed to prevent report users from being misled, the auditor should discuss the matter with management and, if appropriate, those charged with governance, and should include an explanatory paragraph in the audit report describing the nature of the noncompliance. For example, disclosure would be warranted if the discovery of noncompliance in the subsequent period was of such magnitude that it caused the grantor to stop funding the program.

j. **Evaluating Sufficiency & Appropriateness of Audit Evidence and Forming an Opinion** The auditor should evaluate the sufficiency and appropriateness of the audit evidence obtained. The auditor should form an opinion, at the level specified by the governmental audit requirement, on whether the entity complied in all material respects with the applicable compliance requirements, and report appropriately. When determining if the entity materially complied, noncompliance identified by the auditor should be considered even if the entity corrected it once the auditor brought it to management's attention. In forming an opinion, the auditor should evaluate likely questioned costs, not just known questioned costs, as well as other material noncompliance that, by its nature, may not result in questioned costs.

Factors to consider in the determination of whether the entity materially complied with the applicable compliance requirements may include:

- The frequency of noncompliance identified during the compliance audit;
- The nature of the noncompliance identified;
- The adequacy of the entity's system for monitoring compliance and the possible effect of any noncompliance on the entity; and
- Whether any identified noncompliance resulted in likely questioned costs that are material to the government program.

k. **Reporting & Communication Requirements**

(1) **Elements of a Report on Compliance Only** The audit report on compliance should include the following elements:

- (a) A title that includes the word *independent*
- (b) Identification of the one or more government programs covered by the compliance audit or reference to a separate schedule containing that information
- (c) Identification of the applicable compliance requirements or a reference to where they can be found
- (d) Identification of the period covered by the report
- (e) A statement that compliance with the applicable compliance requirements is the responsibility of the entity's management
- (f) A statement that the auditor's responsibility is to express an opinion on the entity's compliance with the applicable compliance requirements based on the compliance audit
- (g) A statement that the compliance audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable

to financial audits contained in *Government Auditing Standards*, and the governmental audit requirement

- (h) A statement that the compliance audit included examining, on a test basis, evidence about the entity's compliance with those requirements and performing such other procedures as the auditor considered necessary in the circumstances
  - (i) A statement that the auditor believes the compliance audit provides a reasonable basis for the auditor's opinion
  - (j) A statement that the compliance audit does not provide a legal determination of the entity's compliance
  - (k) The auditor's opinion, at the level specified by the governmental audit requirement, on whether the entity complied, in all material respects, with the applicable compliance requirements
  - (l) If noncompliance that results in an opinion modification is identified, a description of such noncompliance, or a reference to a description of such noncompliance in an accompanying schedule
  - (m) If other noncompliance that is required to be reported by the governmental audit requirement is identified (that is, noncompliance that does not result in an opinion modification), a description of such noncompliance or a reference to a description of such noncompliance in an accompanying schedule
  - (n) If the criteria used to evaluate compliance are (1) established or determined by contractual agreement or regulatory provisions that are developed solely for the parties to the agreement or regulatory agency responsible for the provisions or (2) available only to the specified parties, a separate paragraph at the end of the report that includes (1) a statement indicating that the report is intended solely for the information and use of the specified parties (2) an identification of the specified parties to whom use is restricted, and (3) a statement that the report is not intended to be and should not be used by anyone other than the specified parties
  - (o) The manual or printed signature of the auditor's firm
  - (p) The date of the audit report
- (2) **Elements of a Combined Report on Compliance & Internal Control Over Compliance** (See Exhibit 1 of this topic for an example of this report.) If the governmental audit requirement requires the auditor to report on internal control over compliance and the auditor combines the audit report on compliance with a report on internal control over compliance, the elements listed below should be *added* to the report elements listed in (1) (a) – (p).
- (a) A statement that management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, rules, and provisions of contracts or grant agreements applicable to government programs
  - (b) A statement that in planning and performing the compliance audit, the auditor considered the entity's internal control over compliance with the applicable compliance requirements to determine the auditing procedures for the purpose of expressing an opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance
  - (c) A statement that the auditor is not expressing an opinion on internal control over compliance

- (d) A statement that the auditor’s consideration of the entity’s internal control over compliance was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses in internal control over compliance
  - (e) The definition of *deficiency in internal control over compliance* and *material weakness in internal control over compliance*
  - (f) A description of any identified material weaknesses in internal control over compliance or a reference to an accompanying schedule containing such a description
  - (g) If significant deficiencies in internal control over compliance were identified, the definition of *significant deficiency in internal control over compliance* and a description of the deficiencies or a reference to an accompanying schedule containing such a description
  - (h) If no material weaknesses in internal control over compliance were identified, a statement to that effect
  - (i) The restricted use paragraph should be included in all combined reports on the entity’s compliance and internal control over compliance
- (3) **Elements of a Separate Report on Internal Control Over Compliance** If the governmental audit requirement requires the auditor to report on internal control over compliance and the auditor chooses to issue a separate report on internal control over compliance, the auditor should include in that separate report the elements listed in (2) (a) – (i) and the following additional elements:
- (a) A title that includes the word *independent*
  - (b) A statement that the auditor audited the entity’s compliance with applicable compliance requirements pertaining to [*identify the government program(s) and the period audited*] and a reference to the audit report on compliance
  - (c) A statement that the compliance audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and the governmental audit requirement
  - (d) The manual or printed signature of the auditor’s firm
  - (e) The date of the audit report

**Exhibit 1 ▶ Combined Report on Compliance With Applicable Requirements and Internal Control Over Compliance**

<u>Independent Audit Report</u>
[Addressee]
<b>Compliance</b>
We have audited Example Entity’s compliance with the [ <i>identify the applicable compliance requirements or refer to the document that describes the applicable compliance requirements</i> ] applicable to Example Entity’s [ <i>identify the government program(s) audited or refer to a separate schedule that identifies the program(s)</i> ] for the year ended June 30, 20X1. Compliance with the requirements referred to above is the responsibility of Example Entity’s management. Our responsibility is to express an opinion on Example Entity’s compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and [insert the name of the governmental audit requirement or program-specific audit guide]. Those standards and [insert the name of the governmental audit requirement or program-specific audit guide] require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the compliance requirements referred to above that could have a material effect on [identify the government program(s) audited or refer to a separate schedule that identifies the program(s)] occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the compliance requirements referred to above that are applicable to [identify the government program(s) audited] for the year ended June 30, 20X1.

#### **Internal Control Over Compliance**

Management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the compliance requirements referred to above. In planning and performing our audit, we considered Example Entity's internal control over compliance to determine the auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Example Entity's internal control over compliance.

A *deficiency in internal control over compliance* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses in internal control over compliance. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the entity, [identify the legislative or regulatory body], and [identify the grantor agency(ies)] and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

- (4) **Other Reporting Requirements** The auditor should report noncompliance as well as other matters that are required to be reported by the governmental audit requirement in the manner specified by the governmental audit requirement. If the other matters required to be reported by the governmental audit requirement are not appropriate for the auditor to report on, the auditor should attach a separate report.

- (5) **Material Noncompliance or Scope Restriction** The auditor should modify the opinion on compliance in accordance with AU 508, *Reports on Audited Financial Statements*, if any of the following conditions exist:
    - (a) The compliance audit identifies noncompliance with the applicable compliance requirements that the auditor believes has a material effect on the entity's compliance.
    - (b) A restriction on the scope of the compliance audit
  - (6) **Reference to Another Auditor** The auditor should modify the report when the auditor makes reference to the report of another auditor as the basis, in part, for the audit report.
  - (7) **Printed Forms** Printed forms, schedules, or reports designed or adopted by government agencies with which they are to be filed sometimes contain prescribed wording. If these require the auditor to make a statement that the auditor has no basis to make, the auditor should accordingly reword the form, schedule, or report or attach an appropriately worded separate report.
  - (8) **Reissuance of a Compliance Report** If an auditor reissues a report, it should include an explanatory paragraph stating that the report is replacing a previously issued report and describing the reasons why it is being reissued, and any changes from the previously issued report. Reissuance of an auditor-prepared document required by the governmental audit requirement that is incorporated by reference into the audit report is considered to be a reissuance of the report.
    - (a) **Additional Procedures Performed for All Programs** If additional procedures are performed for all of the government programs being reported on, the audit report date should be updated to reflect the date the auditor obtained sufficient appropriate audit evidence regarding the events that caused the auditor to perform the new procedures.
    - (b) **Additional Procedures Performed for Only Some Programs** If additional procedures are performed for only some of the government programs, the auditor should dual date the report with the updated report date reflecting the date the auditor obtained sufficient appropriate audit evidence regarding the government programs affected by the circumstances and referencing the government programs for which additional audit procedures have been performed.
  - (9) **Communication Requirements**
    - (a) In the absence of a governmental audit requirement to report on internal control over compliance, the auditor should, nevertheless, communicate in writing to management and those charged with governance identified significant deficiencies and material weaknesses in internal control over compliance. *Government Auditing Standards* require the auditor to obtain a response from responsible officials, preferably in writing.
    - (b) The auditor also should communicate to those charged with governance of the entity the auditor's responsibilities under GAAS, GAGAS, and the governmental audit requirement; an overview of the planned scope and timing of the compliance audit; and significant findings from the compliance audit.
- I. **Documentation Requirements** The auditor should document:
- (1) The risk assessment procedures performed, including those related to gaining an understanding of internal control over compliance
  - (2) The auditor's responses to the assessed risks of material noncompliance

- (3) The procedures performed to test compliance with the applicable compliance requirements and the results of those procedures, including any tests of controls over compliance
- (4) The materiality levels and the basis on which they were determined
- (5) How the auditor complied with the specific governmental audit requirements that are supplementary to GAAS and GAGAS

Editor note: The auditor is **not** expected to prepare specific documentation of how the auditor adapted and applied each of the applicable AU sections to the objectives of a compliance audit. The documentation of the audit strategy, audit plan, and work performed cumulatively demonstrate whether the auditor has complied with this requirement.

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**SSARS 19, *Compilation and Review Engagements*, paragraph 2.21 (AR 80, *Compilation of Financial Statements*, paragraph 21); issued 12/2009**

In December 2009, the AICPA's Accounting and Review Services Committee issued Statement on Standards for Accounting and Review Services (SSARS) 19, *Compilation and Review Engagements*. The provisions are effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010, with one exception—early implementation is allowed with respect to permitting an accountant to disclose the reasons for a lack of independence in a compilation report. **Therefore, only this portion of the new standard is eligible to be tested beginning with the July-August 2010 exam window.** In addition to this updating supplement, this portion of the new standard is covered in the text that is included with the online courses and within the 13.2 and later versions of the software in Chapter 31. (The 39<sup>th</sup> edition of the textbook was published prior to the release of this new standard. The topic is covered on page 6 of Chapter 31 in the 1<sup>st</sup> section: I.B.3.d.)

Editor note: The remainder of SSARS 19 is eligible to be tested beginning with the July-August 2011 exam window. The authoritative guidance that covers SSARS 19 is AR 60, *Framework for Performing and Reporting on Compilation and Review Engagements*, AR 80, *Compilation of Financial Statements*, and AR 90, *Review of Financial Statements*. These three sections will supersede AR 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services*, AR 50, *Standards for Accounting and Review Services*, and AR 100, *Compilation and Review of Financial Statements*.

**Reporting When Not Independent in a Compilation Engagement** A CPA is **not** required to be independent of an entity to issue a compilation report; however

1. The report should be modified by adding a *final* paragraph that specifically discloses the lack of independence, such as: "I am (We are) not independent with respect to XYZ Company."
2. The CPA may disclose the reason(s) the CPA's independence is impaired in the same final paragraph. If the CPA elects to do this, *all* the reasons should be included.

An example of such a final paragraph disclosing the reason for the impairment of independence is "I am (We are) not independent with respect to XYZ Company as during the year ended December 31, 20XX, I (a member of the engagement team) had a direct financial interest in XYZ Company."

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**SAS 118 (AU 550), *Other Information in Documents Containing Audited Financial Statements*; issued 2/2010**

**This statement is eligible to be tested beginning in the October-November 2010 exam window. Both the previous and the new statement may be tested in the October-November 2010 exam window. Only the new statement will be testable starting with the January-February 2011 exam window.**

It is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

SAS 118 supersedes / replaces the previous guidance in AU 550 of the same title. (The 39<sup>th</sup> edition of the textbook was published prior to the release of this new standard. The topic is covered in the 10<sup>th</sup> section of Chapter 28.)

1. **Auditor's Overall Responsibilities** Generally, the auditor's opinion on the financial statements does **not** cover other information in documents containing audited financial statements and the audit report. Additionally, the auditor has **no** responsibility for determining whether such information is properly stated. (The exception being when there is a separate requirement to do so in the particular circumstances of an engagement.)
  - a. **Read the Other Information Prior to Report Release Date** However, the auditor should read the other information. The auditor should make appropriate arrangements with management or those charged with governance to obtain the other information prior to the report release date. If this is not possible, the auditor should read such other information as soon as practicable. The auditor may also decide to delay the release of the report until the information is provided.
  - b. **Objective** The auditor's purpose is to identify and attempt to resolve possible material *inconsistencies* and apparent material *misstatements of facts* (see definitions below) that could undermine the credibility of the audited financial statements and the audit report. Failing a resolution on the revisions needed, the auditor should respond in a manner that is appropriate for the particular circumstances.
  - c. **Communication** The auditor should communicate with those charged with governance:
    - (1) **Auditor's Responsibilities** The auditor's responsibility with respect to the other information
    - (2) **Procedures & Results** Any procedures performed relating to the other information and the results

Editor note: The auditor's responsibility for other information presented in a document containing audited financial statements that is *required* to be included per an accounting standard is covered in AU 558, *Required Supplementary Information*. (See the section on SAS 120 / AU 558 in this document.) However, if the other information is prepared according to an accounting standard's guidance and is presented *voluntarily*, then it is addressed by this standard—AU 550.

## 2. Audit Report

- a. **Audit Report Reference Not Required** The auditor is **not** required to reference the other information in the audit report.
- b. **Optional Disclaimer** However, the auditor may include an explanatory paragraph disclaiming an opinion on the other information. For example, an auditor may choose to do so when the auditor could be associated with the information and the user may infer a level of assurance that is not intended. An example of such an explanatory paragraph is:

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

### 3. Definitions

- a. **Other information** Financial and nonfinancial information (other than the financial statements and the audit report) that is included in a document containing audited financial statements and the audit report, excluding required supplementary information.

(1) **Examples**

- A report by management or those charged with governance on operations
- Financial summaries or highlights
- Employment data
- Planned capital expenditures
- Financial ratios
- Names of officers and directors
- Selected quarterly data

- (2) **Items Not Considered to be Other Information** Per GAAS, other information does **not**, for example, include a press release or similar memorandum or a cover letter accompanying the document containing audited financial statements and the audit report; information contained in analyst briefings; or information contained on the entity's Web site.

b. **Documents Containing Audited Financial Statements**

- (1) Annual reports (or similar documents) that are issued to owners (or similar stakeholders)
- (2) Annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the audit report
- (3) Other documents to which the auditor, at the client's request, devotes attention.

- c. **Inconsistency (With Financial Statements)** An inconsistency is other information that conflicts with information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion.

- d. **Misstatement of Fact (Unrelated to Financial Statements)** A misstatement of fact is other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

### 4. Procedures for Material Inconsistencies Identified Prior to Report Release Date

- a. **Revision of Financial Statements Needed** If the auditor determines the financial statements should be revised and management refuses, the auditor should modify the auditor's opinion in accordance with AU 508, *Reports on Audited Financial Statements*.

- b. **Revision of Other Information Needed** If the auditor determines the other information should be revised and management refuses, the auditor should respond as follows.

- (1) **Communicate to Those Charged With Governance** The auditor should communicate this matter to those charged with governance.

- (2) Depending on the circumstances and the significance of the inconsistency, the auditor should do one of the following.
- (a) **Add Explanatory Language to Standard Report** Include in the audit report an explanatory paragraph describing the material inconsistency (this does not affect the auditor's unqualified opinion);
  - (b) **Withhold the Audit Report;** or
  - (c) **Withdraw From the Engagement**

When management refuses to revise the other information, the auditor may base any decision on what further action to take on advice from legal counsel.

Editor note: In audits of governmental entities, withdrawal from the engagement or withholding the audit report may not be options. In such cases, the auditor may issue a report to those charged with governance and the appropriate statutory body, if applicable, giving details of the inconsistency.

## 5. Procedures for Material Inconsistencies Identified Subsequent to Report Release Date

### a. Revision of Financial Statements Needed

The auditor should apply the relevant requirements in AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. (See the section on timing issues in Chapter 28.)

### b. Revision of Other Information Needed

- (1) **Management Makes Revision** The auditor should carry out the procedures necessary under the circumstances. These may include reviewing the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the audit report, and the other information are informed of the need for revision.
- (2) **Management Refuses to Revise** The auditor should notify those charged with governance of the auditor's concerns regarding the other information and take any further appropriate action. This may include obtaining advice from legal counsel.

## 6. Procedures for Material Misstatements of Fact Identified

- a. **Discussion With Management** If, on reading the other information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor should discuss the matter with management.
- b. **Consultation With Third Party** If the discussion with management does not resolve the auditor's concerns, the auditor should request that management consult with a qualified third party, such as the entity's legal counsel, and the auditor should consider the advice received by the entity.
- c. **Management Refuses to Revise** If the auditor concludes there is a material misstatement of fact and management refuses to revise the other information, the auditor should notify those charged with governance and take any further appropriate action. This may include obtaining advice from legal counsel, withholding the audit report, or withdrawing from the engagement.

**SAS 119 (AU 551), *Supplementary Information in Relation to the Financial Statements as a Whole*; issued 2/2010**

**This statement is eligible to be tested beginning in the October-November 2010 exam window. Both the previous and the new statement may be tested in the October-November 2010 exam window. Only the new statement will be testable starting with the January-February 2011 exam window.**

It is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

SAS 119 supersedes / replaces the previous guidance in AU 551. The title of AU 551 has also been changed; its new title matches that of SAS 119. (The 39<sup>th</sup> edition of the textbook was published prior to the release of this new standard. The topic is covered in the 1<sup>st</sup> section of Chapter 30.)

### **Reporting on Supplementary Information in Relation to the Financial Statements as a Whole**

**1. Definition of *Supplementary Information*** *Supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information. It is **not** considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements. Examples include:

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

**2. Engagement Objective** Evaluate the presentation of the supplementary information and report on whether it is fairly stated, in all material respects, in relation to the financial statements as a whole.

**3. Required Conditions** The auditor should determine that all of the following conditions are met.

- a. The supplementary information was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.
- b. The supplementary information relates to the same period as the financial statements.
- c. The financial statements were audited, and the auditor served as the principal auditor in that engagement.
- d. Neither an adverse opinion nor a disclaimer of opinion was issued on the financial statements.
- e. The supplementary information will accompany the entity's audited financial statements, or such audited financial statements will be made readily available by the entity.

Editor note: Audited financial statements are deemed to be readily available if a third-party user can obtain the audited financial statements without any further action by the entity. For example, financial statements on an entity's Web site may be considered readily available, but being available upon request is not considered readily available.

**4. Management's Responsibilities** The auditor should obtain the agreement of management that it acknowledges and understands its responsibility:

- a. For the preparation of the supplementary information in accordance with the applicable criteria

- b. To provide the auditor with certain written representations
  - c. To include the audit report on the supplementary information in any document that contains the supplementary information and that indicates that the auditor has reported on such supplementary information
  - d. To present the supplementary information with the audited financial statements or, if the supplementary information will not be presented with the audited financial statements, to make the audited financial statements readily available to the intended users of the supplementary information no later than the date of issuance by the entity of the supplementary information and the audit report thereon.
5. **Written Management Representations** The auditor should obtain written representations from management:
- a. That it acknowledges its responsibility for the presentation of the supplementary information in accordance with the applicable criteria
  - b. That it believes the supplementary information, including its form and content, is fairly presented in accordance with the applicable criteria
  - c. That the methods of measurement or presentation have not changed from those used in the prior period or, if they have, the reasons for such changes
  - d. About any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information
  - e. That when the supplementary information is not presented with the audited financial statements, management will make the audited financial statements readily available to the intended users of the supplementary information no later than the date of issuance by the entity of the supplementary information and the audit report thereon
6. **Other Procedures** In addition to the procedures performed during the audit of the financial statements and obtaining the preceding written representations from management, the auditor should perform the following procedures using the same materiality level used in the audit of the financial statements:
- a. Inquire of management about the purpose of the supplementary information and the criteria used by management to prepare it, such as an applicable financial reporting framework, criteria established by a regulator, a contractual agreement, or other requirements
  - b. Determine whether the form and content of the supplementary information complies with the applicable criteria
  - c. Obtain an understanding about the methods of preparing the supplementary information and determine whether these methods have changed from those used in the prior period and, if so, the reasons for such changes
  - d. Compare and reconcile the supplementary information to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves
  - e. Inquire of management about any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information
  - f. Evaluate the appropriateness and completeness of the supplementary information

Editor note: With respect to the supplementary information, the auditor is **not** required to obtain a separate understanding of the entity's internal control or to assess fraud risk.

7. **Subsequent Events** The auditor has **no** responsibility for the consideration of subsequent events with respect to the supplementary information. However, if information comes to the auditor's attention prior to the release of the audit report on the financial statements regarding subsequent events that affect the financial statements, the auditor should apply the relevant requirements in AU 560, *Subsequent Events*. If information comes to the auditor's attention subsequent to the release of the audit report on the financial statements regarding facts that may have existed at that date, which might have affected the report had the auditor been aware of such facts, the auditor should apply the relevant requirements in AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.
8. **Reporting When Supplementary Information Presented With Financial Statements** The auditor should report on the supplementary information in either
- An explanatory paragraph **following** the opinion paragraph in the audit report on the financial statements or
  - A separate report on the supplementary information

The explanatory paragraph or separate report should include the following elements:

- a. A statement that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole
- b. A statement that the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements
- c. A statement that the supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements
- d. A statement that the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves and other additional procedures, in accordance with auditing standards generally accepted in the United States of America
- e. If the auditor issues an unqualified opinion on the financial statements and has concluded that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, a statement (in the form of an opinion) to that effect

**Exhibit 1 ▶ Supplementary Information Explanatory Paragraph / Unqualified Opinion Issued on Financial Statements & Supplementary Information Fairly Stated**

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

- f. If the auditor issues a qualified opinion on the financial statements and the qualification has an effect on the supplementary information, a statement that, in the auditor's opinion, except for the

effects on the supplementary information of [*describe reason for qualification of the auditor's opinion on the financial statements and reference the explanatory paragraph*], such information is fairly stated, in all material respects, in relation to the financial statements as a whole

**9. Separate Report on Supplementary Information When Supplementary Information Is Not Presented With Financial Statements** When the audited financial statements are **not** presented with the supplementary information, the auditor should report on the supplementary information in a separate report. This report should include, *in addition to the preceding elements*:

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

The auditor may consider restricting the use of a separate report on supplementary information to the appropriate specified parties to avoid potential misinterpretation or misunderstanding of the supplementary information that is not presented with the financial statements.

**Exhibit 2 ▶ Supplementary Information Separate Report / Unqualified Opinion Issued on Financial Statements & Supplementary Information Fairly Stated**

We have audited the financial statements of XYZ Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated [*date of the audit report on the financial statements*] which contained an unqualified opinion on those financial statements. Our audit was performed for the purpose of forming an opinion on the financial statements as a whole. The [*identify supplementary information*] is presented for the purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

**10. Adverse Opinion or Disclaimer of Opinion on Financial Statements Precludes Reporting on Supplementary Information** When the audit report on the financial statements contains an adverse opinion or a disclaimer of opinion, the auditor is precluded from expressing an opinion on whether supplementary information is fairly stated. When permitted by law or regulation, the auditor may withdraw from an engagement to report on the supplementary information. If the auditor does not withdraw, the audit report on the supplementary information should state that because of the significance of the matter disclosed in the audit report, it is inappropriate to, and the auditor does not, express an opinion on the supplementary information.

**Exhibit 3 ▶ Explanatory Paragraph for No Opinion on Supplementary Information Due to Adverse Opinion or Disclaimer of Opinion Issued on Financial Statements**

We were engaged for the purpose of forming an opinion on the basic financial statements as a whole. The [*identify accompanying supplementary information*] is presented for the purposes of additional analysis and is not a required part of the financial statements. Because of the significance of the matter described above [*the auditor may describe the basis for the adverse opinion or disclaimer of opinion*], it is inappropriate to and we do not express an opinion on the supplementary information referred to above.

11. **Date of Audit Report on Supplementary Information** The date of the audit report on the supplementary information should not be earlier than the date on which the auditor completed the procedures required to render an opinion on it.

12. **Supplementary Information Materially Misstated** The auditor should discuss the matter with management and propose appropriate revision of the supplementary information.

If management does **not** revise the supplementary information, the auditor should either:

- a. Modify the auditor's opinion on the supplementary information and describe the misstatement in the audit report or
- b. If a separate report is being issued on the supplementary information, withhold the audit report on the supplementary information

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### SAS 120 (AU 558), *Required Supplementary Information*; issued 2/2010

**This statement is eligible to be tested beginning in the October-November 2010 exam window. Both the previous and the new statement may be tested in the October-November 2010 exam window. Only the new statement will be testable starting with the January-February 2011 exam window.**

It is effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

SAS 120 supersedes / replaces the previous guidance in AU 558 of the same title. (The 39<sup>th</sup> edition of the textbook was published prior to the release of this new standard. The topic is covered in the 11<sup>th</sup> section of Chapter 28.)

1. **Overview / Objective** When a designated accounting standard setter *requires* information to accompany an entity's basic financial statements, the auditor's objective is to perform limited procedures in order to describe (a) the degree of completeness of the required supplementary information (RSI) and (b) its adherence with prescribed guidelines in an explanatory paragraph added to the audit report on the financial statements **following** the opinion paragraph.

No opinion is expressed nor is any assurance provided on the RSI.

Editor note: The auditor's responsibility for financial and nonfinancial information (other than the financial statements and the audit report) that is included in a document containing audited financial statements and the audit report that is **not** required by a designated accounting standard setter, but is presented *voluntarily* by the entity, is addressed in AU 550, *Other Information in Documents Containing Audited Financial Statements*. (See the section on SAS 118 / AU 550 in this document.)

### 2. Definitions

a. **Required Supplementary Information** Information that a designated accounting standard setter requires to accompany an entity's basic financial statements. RSI is **not** part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.

Generally, the auditor's opinion on the basic financial statements does **not** cover RSI. (The exception being when there is a separate requirement to do so in the particular circumstances of an engagement.)

- b. **Designated Accounting Standard Setter** The following bodies have been designated by the AICPA Council to establish GAAP pursuant to Rule 202, *Compliance With Standards* and Rule 203, *Accounting Principles*:
- Financial Accounting Standards Board (FASB)
  - Governmental Accounting Standards Board (GASB)
  - Federal Accounting Standards Advisory Board (FASAB)
  - International Accounting Standards Board (IASB)
- c. **Basic Financial Statements** Financial statements presented in accordance with an applicable financial reporting framework as established by a designated accounting standard setter, excluding RSI.
- d. **Applicable Financial Reporting Framework** The financial reporting framework adopted by management and those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.
- e. **Prescribed Guidelines** The authoritative guidelines established by the designated accounting standard setter for the methods of measurement and presentation of the RSI.
3. **Written Management Representations** The auditor should obtain written representations from management:
- a. That it acknowledges its responsibility for the RSI
  - b. About whether the RSI is measured and presented in accordance with prescribed guidelines
  - c. About whether the methods of measurement or presentation have changed from those used in the prior period and, if so, the reasons for such changes
  - d. About any significant assumptions or interpretations underlying the measurement or presentation of the RSI
4. **Procedures** In addition to obtaining the written representations from management just described, the auditor should apply the following procedures to RSI. If the auditor is unable to complete these procedures due to significant difficulties encountered in dealing with management, the auditor should inform those charged with governance.
- a. Inquire of management about the methods of preparing the information, including:
    - (1) Whether it has been measured and presented in accordance with prescribed guidelines
    - (2) Whether methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes
    - (3) Whether there were any significant assumptions or interpretations underlying the measurement or presentation of the information
  - b. Compare the information for consistency with
    - (1) Management's responses to the foregoing inquiries
    - (2) The basic financial statements
    - (3) Other knowledge obtained during the audit of the basic financial statements

5. **Reporting** The auditor should include an explanatory paragraph in the audit report on the financial statements, **following** the opinion paragraph, to refer to the RSI. It should explain the following circumstances, as applicable.
- a. The RSI is included and the auditor has applied the required procedures.
  - b. Some RSI is missing and some is presented in accordance with the prescribed guidelines.
  - c. The auditor has identified material departures from the prescribed guidelines.
  - d. The auditor is unable to complete the required procedures.
  - e. The auditor has unresolved doubts about whether the RSI is presented in accordance with prescribed guidelines.
  - f. The RSI is omitted.

Editor note: Because the RSI accompanies the basic financial statements, the audit report on the financial statements includes a discussion of the responsibility taken by the auditor on that information. However, because the RSI is **not** part of the basic financial statements, the auditor's opinion on the fairness of presentation of such financial statements in accordance with the applicable financial reporting framework is **not** affected by the presentation by the entity of the RSI or the failure to present some or all of it. Furthermore, if the RSI is omitted by the entity, the auditor does **not** have a responsibility to present it.

6. **Reporting Elements of Explanatory Paragraph When All or Some of the RSI Is Presented**

- a. A statement that [*identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)*] require that the [*identify the required supplementary information*] be presented to supplement the basic financial statements.
- b. A statement that such information, although not a part of the basic financial statements, is required by [*identify designated accounting standard setter*], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.
- c. If the auditor is able to complete the required procedures:
  - (1) A statement that the auditor has applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to the auditor's inquiries, the basic financial statements, and other knowledge the auditor obtained during the audit of the basic financial statements
  - (2) A statement that the auditor does not express an opinion or provide any assurance on the information because the limited procedures do not provide the auditor with sufficient evidence to express an opinion or provide any assurance

**Exhibit 1 ▶ The RSI Is Included, the Auditor Has Applied the Specified Procedures, and No Material Departures From Prescribed Guidelines Have Been Identified**

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

- d. If the auditor is **not** able to complete the required procedures:
- (1) A statement that the auditor was unable to apply certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States because *[state the reasons]*
  - (2) A statement that the auditor does not express an opinion or provide any assurance on the information

**Exhibit 2 ▶ Specified Procedures Not Completed**

*[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require that the *[identify the supplementary information]* on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by *[identify designated accounting standard setter]* who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We were unable to apply certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America because *[state the reasons]*. We do not express an opinion or provide any assurance on the information.

- e. If some of the RSI is omitted:
- (1) A statement that management has omitted *[description of the missing required supplementary information]* that *[identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require to be presented to supplement the basic financial statements
  - (2) A statement that such missing information, although not a part of the basic financial statements, is required by *[identify designated accounting standard setter]*, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
  - (3) A statement that the auditor's opinion on the basic financial statements is not affected by the missing information

Editor note: The elements in "e." above are in addition to the elements in "a." through "c." above.

**Exhibit 3 ▶ Some RSI Is Omitted and Some Is Presented in Accordance With the Prescribed Guidelines**

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

Management has omitted *[describe the missing required supplementary information]* that *[identify the applicable financial reporting framework]* require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by *[identify designated accounting standard setter]* who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

- f. If the measurement or presentation of the RSI departs materially from the prescribed guidelines, a statement that although the auditor's opinion on the basic financial statements is not affected, material departures from prescribed guidelines exist *[describe the material departures from the applicable financial reporting framework]*

**Exhibit 4 ▶ Material Departures From Prescribed Guidelines Identified**

*[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require that the *[identify the supplementary information]* on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by *[identify designated accounting standard setter]* who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. Although our opinion on the basic financial statements is not affected, the following material departures from the prescribed guidelines exist *[identify the required supplementary information and describe the material departures from the prescribed guidelines]*. We do not express an opinion or provide any assurance on the information.

- g. If the auditor has unresolved doubts about whether the RSI is measured or presented in accordance with prescribed guidelines, a statement that although the auditor's opinion on the basic financial statements is not affected, the results of the limited procedures have raised doubts about whether material modifications should be made to the required supplementary information for it to be presented in accordance with guidelines established by *[identify designated accounting standard setter]*

**Exhibit 5► Unresolved Doubts About Whether the RSI Is in Accordance With Prescribed Guidelines**

*[Identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require that the *[identify the supplementary information]* on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by *[identify designated accounting standard setter]* who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance. Although our opinion on the basic financial statements is not affected, the results of the limited procedures have raised doubts about whether material modifications should be made to the required supplementary information for it to be presented in accordance with guidelines established by *[identify designated accounting standard setter]*. *[The auditor may consider including in the report the reason(s) the auditor was unable to resolve the doubts.]*

**7. Reporting Elements of Explanatory Paragraph When All of the RSI Is Omitted**

- a. A statement that management has omitted *[description of the missing required supplementary information]* that *[identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require to be presented to supplement the basic financial statements
- b. A statement that such missing information, although not a part of the basic financial statements, is required by *[identify designated accounting standard setter]*, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context
- c. A statement that the auditor's opinion on the basic financial statements is not affected by the missing information

**Exhibit 6 ► All RSI Omitted**

Management has omitted *[describe the missing required supplementary information]* that *[identify the applicable financial reporting framework (for example, accounting principles generally accepted in the United States of America)]* require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by *[identify designated accounting standard setter]* who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

**SSAE 16 (AT 801), Reporting on Controls at a Service Organization; issued 4/9/2010****Service Auditors (AT 801)**

In April 2010, the AICPA issued SSAE 16 (AT 801), *Reporting on Controls at a Service Organization*. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.

Prior to the issuance of SSAE 16, the guidance for service auditors (CPAs reporting on controls at a service organization relevant to financial reporting) *and* user auditors (CPAs auditing the financial statements of an entity that uses a service organization) was included in AU 324, *Service Organizations*. The AICPA decided that the guidance for service auditors should be moved to the attestation standards (to AT 801) because the examination conducted by service auditors is not an audit of financial statements. (The guidance for user auditors will remain in the auditing standards—in AU 324.)

Thus, the new SSAE supersedes the guidance for service auditors in AU 324, *Service Organizations*. (The 39<sup>th</sup> edition of the textbook was published prior to this standard's issuance. AU 324 is covered in the 4<sup>th</sup> section of Chapter 30.)

**This statement will be eligible to be tested beginning with the January-February 2011 exam window. Both the previous guidance and the new statement are eligible to be tested in the January-February 2011 and the April-May 2011 exam windows. Only the new statement will be testable starting with the July-August 2011 exam window.**

Coverage of this statement will be included in a later version of our updating supplement.

Editor note: AT 801 is applicable when an entity outsources a business task or function to another entity (usually one that specializes in that task or function) and the data resulting from that task or function is incorporated in the outsourcer's financial statements. An entity that performs a specialized task or function for other entities is known as a *service organization* and an entity that outsources the task or function to a service organization is known as a *user entity*.

### **User Auditors (AU 324)**

The AICPA has announced that it has redrafted AU 324 as part of the AICPA's Clarity Project\*. Per the AICPA, the new SAS does *not* contain any significant changes for user auditors, thus this pending SAS will not be covered in our updating supplements. When it becomes effective, the new SAS will replace the guidance for user auditors in AU 324 and the title of AU 324 will be changed from *Service Organizations* to *Audit Considerations Relating to an Entity Using a Service Organization*.

The AICPA has announced that during the interim period before the new SAS for user auditors becomes effective, a notation will be placed at the beginning of AU 324 informing readers that the guidance for service auditors has been superseded by AT 801. This is necessary because the guidance for service auditors that is currently in AU 324 will not be deleted for this interim period. The guidance for service auditors and user auditors currently in AU 324 is so intertwined that if the guidance for service auditors were deleted, the guidance for user auditors would not be meaningful. The guidance for user auditors can be gleaned without deleting the guidance for service auditors.

\* Editor note: The AICPA's Clarity Project is a multiyear effort to make U.S. GAAS easier to read, understand, and apply. Auditing standards issued prior to this initiative will be redrafted (standards issued during the project's existence conform to the new format) and will be assigned the same effective date which has not been determined.

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 ([editor@cpaexam.com](mailto:editor@cpaexam.com)) with details.

Foreword: Page F-29, Diagnostic Exam; Question 3 (7486). The correct answer should be “b” not “a”. The answer explanation is correct.

Chapter 21: Page 21-21, Question 23 (5623). The answer alternatives should be a. Yes, Yes; b. Yes, No; c. No, Yes; and d. No, No.

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## RECENTLY RELEASED AICPA QUESTIONS AND ANSWERS

In April 2010, the AICPA released fifty multiple-choice questions and one simulation relating to the AUD section of the CPA Examination. These questions and their unofficial answers are reproduced here, along with the exclusive Bisk Education explanations. The reference to the Content Specification Outline (CSO) at the end of each answer explanation pertains to the current CSO still in effect for the July-August and October-November 2010 exam windows, not the upcoming CSO which will not be effective until January 1, 2011. Unlike previous year's releases, the multiple-choice questions were not labeled *moderate* or *hard* and they did not contain a skill designation by the AICPA examiners such as *analysis*, *judgment*, or *understanding*. The AICPA did not state if these questions ever appeared on any exam; whether they were assigned points or were merely being pretested (and earned no points) if they did appear on an exam; or if they were now obsolete for some reason. These questions are intended only as a study aid and should not be used to predict the content of future exams. It is the AICPA's policy that released questions will not appear on future exams. These questions have been reproduced as received from the AICPA examiners. If candidates encounter what they believe are errors or ambiguities in questions during the actual exam, they should bring them to the attention of the examiners in accordance with the procedures outlined on the AICPA's Uniform CPA Examination Web site ([www.cpa-exam.org](http://www.cpa-exam.org)).

**Problem 1** MULTIPLE-CHOICE QUESTIONS

1. Which of the following would be an appropriate title for a statement of revenue and expenses prepared using an other comprehensive basis of accounting (OCBOA)?
  - a. Statement of operations
  - b. Statement of income-regulatory basis
  - c. Income statement
  - d. Statement of activities(R/10, AUD, #1, 9351)
  
2. An accountant has been engaged to review a nonissuer's financial statements that contain several departures from GAAP. Management is unwilling to revise the financial statements, and the accountant believes that modification of the standard review report is inadequate to communicate the deficiencies. Under these circumstances, the accountant should
  - a. Determine the effects of the departures from GAAP and issue a special report on the financial statements
  - b. Express a disclaimer of opinion on the financial statements and advise the board of directors that the financial statements should **not** be relied on
  - c. Inform management that a review of the financial statements **cannot** be completed and request a change from a review to a compilation engagement
  - d. Withdraw from the engagement and provide **no** further services concerning these financial statements(R/10, AUD, #2, 9352)
  
3. An independent auditor must have which of the following?
  - a. A pre-existing and well-informed point of view with respect to the audit
  - b. Technical training that is adequate to meet the requirements of a professional
  - c. A background in many different disciplines
  - d. Experience in taxation that is sufficient to comply with generally accepted auditing standards(R/10, AUD, #3, 9353)
  
4. Which of the following conditions most likely would pose the greatest risk in accepting a new audit engagement?
  - a. Staff will need to be rescheduled to cover this new client.
  - b. There will be a client-imposed scope limitation.
  - c. The firm will have to hire a specialist in one audit area.
  - d. The client's financial reporting system has been in place for 10 years.(R/10, AUD, #4, 9354)

5. Which of the following information that comes to an auditor's attention most likely would raise a question about the occurrence of illegal acts?
- The exchange of property for similar property in a nonmonetary transaction
  - The discovery of unexplained payments made to government employees
  - The presence of several difficult-to-audit transactions affecting expense accounts
  - The failure to develop adequate procedures that detect unauthorized purchases (R/10, AUD, #5, 9355)
6. Which of the following steps should an auditor perform first to determine the existence of related parties?
- Examine invoices, contracts, and purchasing orders
  - Request a list of related parties from management
  - Review the company's business structure
  - Review proxy and other materials filed with the SEC (R/10, AUD, #6, 9356)
7. Which of the following payroll control activities would most effectively ensure that payment is made only for work performed?
- Require all employees to record arrival and departure by using the time clock
  - Have a payroll clerk recalculate all time cards
  - Require all employees to sign their time cards
  - Require employees to have their direct supervisors approve their time cards (R/10, AUD, #7, 9357)
8. Which of the following factors is most likely to affect the extent of the documentation of the auditor's understanding of a client's system of internal controls?
- The industry and the business and regulatory environments in which the client operates
  - The degree to which information technology is used in the accounting function
  - The relationship between management, the board of directors, and external stakeholders
  - The degree to which the auditor intends to use internal audit personnel to perform substantive tests (R/10, AUD, #8, 9358)
9. Green, CPA, is auditing the financial statements of Ajax Co. Ajax uses the DP Service Center to process its payroll. DP's financial statements are audited by Blue, CPA, who recently issued a report on DP's policies and procedures regarding the processing of other entity's transactions. In considering whether Blue's report is satisfactory for Green's purposes, Green should
- Make inquiries concerning Blue's professional reputation
  - Assess control risk at the maximum level
  - Review the audit programs followed by Blue
  - Perform tests of controls at the DP Service Center (R/10, AUD, #9, 9359)
10. Which of the following procedures is considered a test of controls?
- An auditor reviews the entity's check register for unrecorded liabilities.
  - An auditor evaluates whether a general journal entry was recorded at the proper amount.
  - An auditor interviews and observes appropriate personnel to determine segregation of duties.
  - An auditor reviews the audit workpapers to ensure proper sign-off. (R/10, AUD, #10, 9360)
11. Which of the following would be a consideration in planning a sample for a test of subsequent cash receipts?
- Preliminary judgments about materiality levels
  - The amount of bad debt write-offs in the prior year
  - The size of the intercompany receivable balance
  - The auditor's allowable risk of assessing control risk is too low (R/10, AUD, #11, 9361)

12. An auditor's analytical procedures indicate a lower than expected return on an equity method investment. This situation most likely could have been caused by
- An error in recording amortization of the excess of the investor's cost over the investment's underlying book value
  - The investee's decision to reduce cash dividends declared per share of its common stock
  - An error in recording the unrealized gain from an increase in the fair value of available-for-sale securities in the income account for trading securities
  - A substantial fluctuation in the price of the investee's common stock on a national stock exchange (R/10, AUD, #12, 9362)
13. Under which of the following conditions may an auditor's observation procedure for inventory be performed during or after the end of the period under audit?
- When the client maintains periodic inventory records
  - When the auditor finds minimal variations in client records and test counts in prior periods
  - When total inventory has **not** varied more than 5% in the last five years
  - When well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts (R/10, AUD, #13, 9363)
14. Which of the following is a computer-assisted audit technique that permits an auditor to insert the auditor's version of a client's program to process data and compare the output with the client's output?
- Test data module
  - Frame relay protocol
  - Remote node router
  - Parallel simulation (R/10, AUD, #14, 9364)
15. What is an auditor's primary method to corroborate information on litigation, claims, and assessments?
- Examining legal invoices sent by the client's attorney
  - Verifying attorney-client privilege through interviews
  - Reviewing the response from the client's lawyer to a letter of audit inquiry
  - Reviewing the written representation letter obtained from management (R/10, AUD, #15, 9365)
16. Which of the following management roles would typically be acknowledged in a management representation letter?
- Management has the responsibility for the design of controls to detect fraud.
  - Management communicates its views on ethical behavior to its employees.
  - Management's knowledge of fraud is communicated to the audit committee.
  - Management's compensation is contingent upon operating results. (R/10, AUD, #16, 9366)
17. Before reissuing a compilation report on the financial statements of a nonissuer for the prior year, the predecessor accountant is required to
- Make inquiries about actions taken at meetings of the board of directors during the current year
  - Verify that the reissued report will **not** be used to obtain credit from a financial institution
  - Review the successor accountant's working papers for matters affecting the prior year
  - Compare the prior year's financial statements with those of the current year (R/10, AUD, #17, 9367)
18. Which of the following procedures would a CPA ordinarily perform when reviewing the financial statements of a nonissuer in accordance with *Statements on Standards for Accounting and Review Services (SSARS)*?
- Apply year-end cutoff tests for the sales and purchasing functions
  - Compare the financial statements with budgets or forecasts
  - Obtain an understanding of the entity's internal control components
  - Document whether control risk is assessed at or below the maximum level (R/10, AUD, #18, 9368)

19. What type of evidence would provide the highest level of assurance in an attestation engagement?
- Evidence secured solely from within the entity
  - Evidence obtained from independent sources
  - Evidence obtained indirectly
  - Evidence obtained from multiple internal inquiries (R/10, AUD, #19, 9369)
20. When performing a substantive test of a random sample of cash disbursements, an auditor is supplied with a photocopy of vendor invoices supporting the disbursements for one particular vendor rather than the original invoices. The auditor is told that the vendor's original invoices have been misplaced. What should the auditor do in response to this situation?
- Increase randomly the number of items in the substantive test to increase the reliance that may be placed on the overall test
  - Reevaluate the risk of fraud, and design alternate tests for the related transactions
  - Increase testing by agreeing more of the payments to this particular vendor to the photocopies of its invoices
  - Count the missing original documents as misstatements, and project the total amount of the error based on the size of the population and the dollar amount of the errors (R/10, AUD, #20, 9370)
21. An auditor finds several errors in the financial statements that the client prefers not to correct. The auditor determines that the errors are not material in the aggregate. Which of the following actions by the auditor is most appropriate?
- Document the errors in the summary of uncorrected errors, and document the conclusion that the errors do **not** cause the financial statements to be misstated
  - Document the conclusion that the errors do **not** cause the financial statements to be misstated, but do **not** summarize uncorrected errors in the working papers
  - Summarize the uncorrected errors in the working papers, but do **not** document whether the errors cause the financial statements to be misstate
  - Do **not** summarize the uncorrected errors in the working papers, and do **not** document a conclusion about whether the uncorrected errors cause the financial statements to be misstated (R/10, AUD, #21, 9371)
22. When qualifying an opinion because of an insufficiency of audit evidence, an auditor should refer to the situation in the
- |    | <u>Scope paragraph</u> | <u>Notes to the<br/>financial statements</u> |                        |
|----|------------------------|--|------------------------|
| a. | Yes                    | Yes  |                        |
| b. | Yes                    | No   |                        |
| c. | No                     | Yes  |                        |
| d. | No                     | No   | (R/10, AUD, #22, 9372) |
23. An accountant compiled the financial statements of a nonissuer in accordance with *Statements on Standards for Accounting and Review Services* (SSARS). If the accountant has an ownership interest in the entity, which of the following statements is correct?
- The accountant should refuse the compilation engagement.
  - A report need **not** be issued for a compilation of a nonissuer.
  - The accountant should include the disclaimer "I am an owner of the entity" in the report.
  - The accountant should include the statement "I am **not** independent with respect to the entity" in the compilation report. (R/10, AUD, #23, 9373)

24. Which of the following is correct about reporting on compliance with laws and regulations in a financial audit under *Government Auditing Standards* (the “Yellow Book”)?
- Auditors are **not** required to report fraud, illegal acts, and other material noncompliance in the audit report.
  - In some circumstances, auditors are required to report fraud and illegal acts directly to parties external to the audited entity.
  - The auditor’s key findings of the audit of the financial statements should be communicated in a separate report.
  - The reporting standards in a governmental audit modify the auditor’s responsibilities under generally accepted auditing standards. (R/10, AUD, #24, 9374)
25. Reports are considered special reports when issued in conjunction with
- Interim financial information reviewed to determine whether material modifications should be made to conform with GAAP
  - Feasibility studies presented to illustrate an entity’s results of operations
  - Compliance with aspects of regulatory requirements related to audited financial statements
  - Pro forma financial presentations designed to demonstrate the effects of hypothetical transactions (R/10, AUD, #25, 9375)

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**Problem 2 ADDITIONAL MULTIPLE-CHOICE QUESTIONS**

26. An accountant is required to comply with the provisions of *Statements on Standards for Accounting and Review Services* (SSARS) when
- |   |  |
|---|--|
| <p style="text-align: center;"><u>Compiling financial statements<br/>generated through<br/>the use of computer software</u></p> | <p style="text-align: center;"><u>Reproducing client prepared<br/>financial statements, without<br/>modification, for the client</u></p> |
| <p>a. Yes</p> <p>b. Yes</p> <p>c. No</p> <p>d. No</p>   | <p>a. Yes</p> <p>b. No</p> <p>c. Yes</p> <p>d. No</p>  |
- (R/10, AUD, #26, 9376)
27. How does Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, define a subrecipient?
- As a nonfederal entity that provides a federal award to another entity to carry out a federal program
  - As an individual who receives and expends federal awards received from a pass-through entity
  - As a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a federal program
  - As a nonfederal entity that expends federal awards received from another entity to carry out a federal program (R/10, AUD, #27, 9377)
28. Which of the following outcomes is a likely benefit of information technology used for internal control?
- Processing of unusual or nonrecurring transactions
  - Enhanced timeliness of information
  - Potential loss of data
  - Recording of unauthorized transactions (R/10, AUD, #28, 9378)
29. Analytical procedures are most appropriate when testing which of the following types of transactions?
- Payroll and benefit liabilities
  - Acquisitions and disposals of fixed assets
  - Operating expense transactions
  - Long-term debt transactions (R/10, AUD, #29, 9379)


30. During the audit of a new client, the auditor determined that management had given illegal bribes to municipal officials during the year under audit and for several prior years. The auditor notified the client's board of directors, but the board decided to take no action because the amounts involved were immaterial to the financial statements. Under these circumstances, the auditor should
- Add an explanatory paragraph emphasizing that certain matters, while **not** affecting the unqualified opinion, require disclosure
  - Report the illegal bribes to the municipal official at least one level above those persons who received the bribes
  - Consider withdrawing from the audit engagement and disassociating from future relationships with the client
  - Issue an "except for" qualified opinion or an adverse opinion with a separate paragraph that explains the circumstances (R/10, AUD, #30, 9380)
31. Which of the following procedures would be most appropriate for testing the completeness assertion as it applies to inventory?
- Scanning perpetual inventory, production, and purchasing records
  - Examining paid vendor invoices
  - Tracing inventory items from the tag listing back to the physical inventory quantities
  - Performing cutoff procedures for shipping and receiving (R/10, AUD, #31, 9381)
32. Which of the following activities performed by a department supervisor most likely would help in the prevention or detection of a payroll fraud?
- Distributing paychecks directly to department employees
  - Setting the pay rate for department employees
  - Hiring employees and authorizing them to be added to payroll
  - Approving a summary of hours each employee worked during the pay period (R/10, AUD, #32, 9382)
33. An auditor is concerned about a policy of management override as a limitation of internal control. Which of the following tests would best assess the validity of the auditor's concern?
- Matching purchase orders to accounts payable
  - Verifying that approved spending limits are **not** exceeded
  - Tracing sales orders to the revenue account
  - Reviewing minutes of board meetings (R/10, AUD, #33, 9383)
34. When an auditor plans to rely on controls that have changed since they were last tested, which of the following courses of action would be most appropriate?
- Test the operating effectiveness of such controls in the current audit
  - Document that reliance and proceed with the original audit strategy
  - Inquire of management as to the effectiveness of the controls
  - Report the reliance in the report on internal controls (R/10, AUD, #34, 9384)
35. In which of the following circumstances would an auditor expect to find that an entity implemented automated controls to reduce risks of misstatement?
- When errors are difficult to predict
  - When misstatements are difficult to define
  - When large, unusual, or nonrecurring transactions require judgment
  - When transactions are high-volume and recurring (R/10, AUD, #35, 9385)


36. Which of the following explanations best describes why an auditor may decide to reduce tests of details for a particular audit objective?
- The audit is being performed soon after the balance sheet date.
  - Audit staff are experienced in performing the planned procedures.
  - Analytical procedures have revealed **no** unusual or unexpected results.
  - There were many transactions posted to the account during the period. (R/10, AUD, #36, 9386)
37. During the confirmation of accounts receivable, an auditor receives a confirmation via the client's fax machine. Which of the following actions should an auditor take?
- Not accept the confirmation and select another customer's balance to confirm
  - Not accept the confirmation and treat it as an exception
  - Accept the confirmation and file it in the working papers
  - Accept the confirmation but verify the source and content through a telephone call to the respondent (R/10, AUD, #37, 9387)
38. Which of the following tests of details most likely would help an auditor determine whether accounts payable have been misstated?
- Examining reported purchase returns that appear too low
  - Examining vendor statements for amounts **not** reported as purchases
  - Searching for customer-returned goods that were **not** reported as returns
  - Reviewing bank transfers recorded as cash received from customers (R/10, AUD, #38, 9388)
39. An audit client sells 15 to 20 units of product annually. A large portion of the annual sales occur in the last month of the fiscal year. Annual sales have not materially changed over the past five years. Which of the following approaches would be most effective concerning the timing of audit procedures for revenue?
- The auditor should perform analytical procedures at an interim date and discuss any changes in the level of sales with senior management.
  - The auditor should inspect transactions occurring in the last month of the fiscal year and review the related sale contracts to determine that revenue was posted in the proper period.
  - The auditor should perform tests of controls at an interim date to obtain audit evidence about the operational effectiveness of internal controls over sales.
  - The auditor should review period-end compensation to determine if bonuses were paid to meet earnings goals. (R/10, AUD, #39, 9389)
40. An auditor should be aware of subsequent events that provide evidence concerning conditions that did not exist at year-end but arose after year-end. These events may be important to the auditor because they may
- Require adjustments to the financial statements as of the year-end
  - Have been recorded based on preliminary accounting estimates
  - Require disclosure to keep the financial statements from being misleading
  - Have been recorded based on year-end tests for asset obsolescence (R/10, AUD, #40, 9390)
41. Which of the following disagreements between the auditor and management do **not** have to be communicated by the auditor to those charged with governance?
- Disagreements regarding management's judgment about accounting estimates for goodwill
  - Disagreements about the scope of the audit
  - Disagreements in the application of accounting principles relating to software development costs
  - Disagreements of the amount of the LIFO inventory layer based on preliminary information (R/10, AUD, #41, 9391)


42. Which of the following is required of an accountant in reviewing a company's financial statements under *Statements on Standards for Accounting and Review Services (SSARS)*?
- Obtain knowledge of the client's industry
  - Send bank confirmations
  - Obtain a signed engagement letter from the client
  - Observe client's physical inventory
- (R/10, AUD, #42, 9392)
43. Which of the following procedures should an accountant perform during an engagement to compile prospective financial statements?
- Test the entity's internal controls to determine if adequate controls exist so that financial projections can be reasonably achieved
  - Make inquiries prior to the date of the report about possible future transactions that may impact the forecast once the report is issued
  - Make inquiries about the accounting principles used in the preparation of the prospective financial statements
  - Compare the prospective financial statements with the entity's historical results for the prior year
- (R/10, AUD, #43, 9393)
44. When applying analytical procedures during an audit, which of the following is the best approach for developing expectations?
- Considering unaudited account balances and ratios to calculate what adjusted balances should be
  - Identifying reasonable explanations for unexpected differences before talking to client management
  - Considering the pattern of several unusual changes without trying to explain what caused them
  - Comparing client data with client-determined expected results to reduce detailed tests of account balances
- (R/10, AUD, #44, 9394)
45. Which of the following statements is most accurate regarding sufficient and appropriate documentation?
- Accounting estimates are **not** considered sufficient and appropriate documentation.
  - Sufficient and appropriate documentation should include evidence that the audit working papers have been reviewed.
  - If additional evidence is required to document significant findings or issues, the original evidence is **not** considered sufficient and appropriate and therefore should be deleted from the working papers.
  - Audit documentation is the property of the client, and sufficient and appropriate copies should be retained by the auditor for at least five years.
- (R/10, AUD, #45, 9395)
46. If **not** already performed during the overall review stage of the audit, the auditor should perform analytical procedures relating to which of the following transaction cycles?
- Payroll
  - Revenue
  - Purchasing
  - Inventory
- (R/10, AUD, #46, 9396)
47. Which of the following services, if any, may an accountant who is **not** independent provide?
- Compilations, but **not** reviews
  - Reviews, but **not** compilations
  - Both compilations and reviews
  - No services
- (R/10, AUD, #47, 9397)


48. Which of the following situations would preclude an accountant from issuing a review report on a company's financial statements in accordance with *Statements on Standards for Accounting and Review Services (SSARS)*?
- a. The owner of a company is the accountant's father.
  - b. The accountant was engaged to review only the balance sheet.
  - c. Land has been recorded at appraisal value instead of historical cost.
  - d. Finished-goods inventory does **not** include any overhead amounts. (R/10, AUD, #48, 9398)
49. Which of the following components is appropriate in a practitioner's report on the results of applying agreed-upon procedures?
- a. A list of the procedures performed, as agreed to by the specified parties identified in the report.
  - b. A statement that management is responsible for expressing an opinion.
  - c. A title that includes the phrase "independent audit."
  - d. A statement that the report is unrestricted in its use. (R/10, AUD, #49, 9399)
50. An auditor may report on condensed financial statements that are derived from a complete set of audited financial statements only if the auditor
- a. Expresses an unqualified opinion on the audited financial statements from which the condensed financial statements are derived
  - b. Indicates whether the information is fairly stated in all material respects in relation to the complete financial statements
  - c. Determines that the condensed financial statements include all the disclosures necessary for the complete set of financial statements
  - d. Presents the condensed financial statements in comparative form with the prior year's condensed financial statements (R/10, AUD, #50, 9400)
-

## Problem 3 SIMULATION

 Analytics

 Audit Procedures

 Attorney Letters

 Communication

You are the audit manager assigned to Joe's Office Supply. Based on substantive test work, the staff auditor has proposed the journal entries below to be presented to the client. Assume all proposed journal entries are valid and material.

For each journal entry, determine whether the ratios in columns D, E, and F *decreased*, *increased*, or had *no impact*. An answer may be used once, more than once, or not at all.

A	B	C	D	E	F
Proposed Journal Entry	Debit	Credit	Earnings per Share	Days Sales in Accounts Receivable	Gross Profit
1. Sales reported after year-end that should have been reported before year-end: Cost of sales                      90 Accounts receivable            100 Sales                                      100 Inventory                                90					
2. Error in adjusting entry: Cost of sales                      45 PP&E                                      45 Utilities expense                12 Cash                                        10 Sales                                      45 Accrued expenses                12 Inventory                                45 Interest expense                    10					
3. To record current and deferred income taxes: Income tax expense-current    50 Deferred tax asset                15 Income tax expense-deferred    10 Deferred tax liability                5 Income tax payable                50					

Analytics

**Audit Procedures**

Attorney Letters

Communication

During the year 1 audit of Numbaro Co., the auditor performed various procedures.

For each of the audit procedures listed below, select the type of audit procedure, if any, that the auditor performed. A type of audit procedure may be selected once, more than once, or not at all.

Audit Procedures	Type of Audit Procedures
1. During the physical inventory count, the auditor requested that certain material containers be opened to ensure they were not empty.	
2. During a site visit to a branch warehouse, the auditor noted unauthorized personnel have access to the inventory.	
3. The auditor obtained a copy of the company's accounting manual and read the section on inventory to prepare for the physical inventory observation.	
4. The auditor sent a letter to the company's outside attorney accompanied by management's request for information concerning pending or threatened litigation, claims, and assessments.	
5. The auditing firm's computer assisted audit specialist obtained an electronic billing file from the company and checked the accuracy of the summarized billings file.	
6. The auditor obtained the company's aging of accounts receivable and independently created the aging of certain accounts.	
7. The auditor scanned the repairs and maintenance account for unusually large amounts.	

Selection List for Types of Audit Procedures	
Analytical	Inspection
Certifying	Monetizing
Compliance	Observation
Confirmation	Recalculation
Guaranteeing	Reperformance
Inquiry	Valuation

[Search Box]

 Analytics

 Audit Procedure

 **Attorney Letters**

 Communication

The following situations represent excerpts from the responses to audit inquiries of external legal counsel of XYZ Co. during the annual audit of year 1. For each excerpt, select the most appropriate audit response related to the financial statements in the audit response (financials) column. Then, in the audit response (report) column, select whether the auditor’s report or the attorney’s legal response letter needs to be updated; or if it is appropriately dated. Each excerpt is independent. Responses may be used once, more than once, or not at all.

- The client’s year-end is December 31, year 1
- The anticipated audit report date is February 15, year 2
- All amounts are material to the financial statements

Situations	Audit Response (Financials)	Audit Response (Report)
1. Letter dated February 14, year 2: “I advise you that at and since December 31, year 1, I have not been engaged to give substantive attention to, or represent XYZ Co. in connection with any pending or threatened litigation, claims, or assessments, nor am I aware of any loss contingencies. No amounts were due to this office for services provided at December 31, year 1.”		
2. Letter dated January 21, year 2: “I advise you that at and since December 31, year 1, I have not been engaged to give substantive attention to, or represent XYZ Co. in connection with any pending or threatened litigation, claims, or assessments, nor am I aware of any loss contingencies. There were fees outstanding of \$3,675 due to this office for services provided at December 31, year 1.”		
3. Letter dated February 26, year 2: “I advise you that at and since December 31, year 1, I have not been engaged to give substantive attention to, or represent XYZ Co. in connection with any pending or threatened litigation, claims, or assessments, except as follows:  K. Bowt v. XYZ Co.: This matter commenced in December, year 1. The plaintiff alleges discrimination relating to his termination on November 17, year 1. The company intends to defend this case vigorously. At this time, we are unable to evaluate the likelihood of an unfavorable outcome or estimate the amount or range of potential loss.		

Situations	Audit Response (Financials)	Audit Response (Report)
<p>4. Letter dated March 16, year 2:                      "I advise you that at and since December 31, year 1, I have not been engaged to give substantive attention to, or represent XYZ Co. in connection with any pending or threatened litigation, claims, or assessments, except as follows:                      J. Myers v. XYZ Co.: This matter commenced in March, year 2. The plaintiff alleges discrimination relating to his termination on November 17, year 1. The company intends to defend this case vigorously. At this time, we are unable to evaluate the likelihood of an unfavorable outcome. The plaintiff is demanding \$50,000.</p>		
<p>5. Letter dated January 10, year 2:                      "I advise you that at and since December 31, year 1, I have not been engaged to give substantive attention to, or represent XYZ Co. in connection with any pending or threatened litigation, claims, or assessments, except as follows:                      R. Brown v. XYZ Co.: This matter commenced in November, year 1. The plaintiff alleges discrimination relating to his termination on March 17, year 1. The case was tentatively settled for \$35,000, which will be covered by XYZ's insurance carrier.</p>		
<p>6. Letter dated January 20, year 2:                      "I advise you that at and since December 31, year 1, I have not been engaged to give substantive attention to, or represent XYZ Co. in connection with any pending or threatened litigation, claims, or assessments, except as follows:                      L. Peep v. XYZ Co.: This matter commenced in November, year 1. The plaintiff alleges discrimination relating to his termination on March 17, year 1. The case was tentatively settled for \$35,000.</p>		

Selection List for Audit Responses (Financials)	
A. Disclosure in the notes to the financial statements relating to nature of litigation, but no amount disclosed	D. Potential litigation settlement accrued in financial statements
B. Disclosure in the notes to the financial statements relating to nature of litigation, including loss amount	E. Potential litigation settlement not accrued in financial statements, amount disclosed in the notes to the financial statements
C. No impact on financial statements or the notes to the financial statements	F. Verify amount due attorney is recorded in financial statements

Selection List for Audit Responses (Report)
Legal response is appropriately dated
Update report date
Update legal response



During the preliminary fieldwork on this engagement, a member of the audit team brings to your attention the following suspicious activities:

- Supporting vendor invoices were missing for several purchase transactions with the same vendor.
- Second endorsements were found on several checks in a particular month.

As the engagement manager, it appears to you that these observations may be indicative of fraudulent activities. Write a memo to the engagement partner explaining why these observations may indicate fraudulent activities. In your response, you should assume that the suspicious events occurred at odd times of the month and were in amounts too high, too low, too consistent, or too different.

**Reminder:** On the actual exam, your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.



While preparing the auditor’s report, the audit assistant believes that the auditor’s report can never reference the findings of a specialist. The audit manager disagrees. Which citation in the professional standards supports the audit manager’s position?

**Reminder:** On the actual exam, you will use an electronic database of authoritative literature to find and select the reference (appropriate section and paragraph of the relevant guidance). Please see the AICPA’s tutorial and sample test on their exam Web site ([www.cpa-exam.org](http://www.cpa-exam.org)).

Paragraph Reference Answer \_\_\_\_\_ (R/10, AUD, 9442)

**Solution 1** MULTIPLE-CHOICE ANSWERS

1. (b) *Statement of income—regulatory basis* is an example of an appropriate format for a title of a financial statement prepared on a statutory or regulatory basis, i.e., an other comprehensive basis of accounting (OCBOA). Terms such as statement of operations and income statement are generally understood to be applicable only to financial statements that are intended to present results of operations in conformity with GAAP. A statement of activities is a financial statement prepared in accordance with GAAP by a not-for-profit organization. Note: If OCBOA financial statements are not suitably titled, the auditor should qualify the opinion, disclosing the auditor's reservations in an explanatory paragraph added to the report. (Chapter 30-II-B; 9351; CSO: V.A.10)

2. (d) If modification of the standard review (or compilation) report is inadequate to communicate the deficiencies in the financial statements due to departures from GAAP, the accountant should withdraw from the engagement and provide no further services concerning these financial statements. The accountant may wish to consult with legal counsel. Under these circumstances it would not be an option for the accountant to determine the effects of the departures and issue a special report; disclaim an opinion; or change from a review engagement to a compilation engagement because the accountant is precluded from providing further services with respect to these financial statements, (Chapter 31-I-D; 9352; CSO: V.A.2)

3. (b) The first general standard states that the auditor must have adequate technical training and proficiency to perform the audit. The attainment of that proficiency begins with the auditor's formal education and extends into the auditor's subsequent experience. The independent auditor must undergo technical training that is adequate to meet the requirements of a professional. The other answer alternatives are not requirements. (Chapter 21-II-D; 9353; CSO: I.A.1)

4. (b) A client-imposed scope limitation poses the greatest risk in accepting a new audit engagement. The other answer alternatives involve fairly routine planning considerations. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, may require the auditor to qualify the opinion or to disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion. (Chapter 21-IV-B; 9354; CSO: I.B.3)

5. (b) The discovery of unexplained payments made to government employees would most likely raise a question about the occurrence of illegal acts. The exchange of property for similar property in a nonmonetary transaction is not an indicator of an illegal act. Failure to develop adequate procedures that detect unauthorized purchases and difficult-to-audit expense account transactions are causes for concern, but they are not as strong an indicator of a possible illegal act as unexplained payments to government officials. (Chapter 22-VII-A; 9355; CSO: III.A.5)

6. (b) One of the first steps an auditor should perform to determine the existence of related parties is to request a list of related parties from management. Reviewing proxy and other material filed with the SEC is a close second choice, but it is usually best to start with inquiries to management and then corroborate those results with the SEC and other regulatory agencies. Reviewing the company's business structure should be done to determine the scope of work to be performed with respect to possible transactions with related parties rather than determining their existence. Examining invoices, contracts, and purchase orders would be done after related party transactions have been identified rather than to determine their existence. It would be done to obtain satisfaction or evidence concerning the purpose, nature, and extent of related party transactions and their effect on the financial statements. (Chapter 24-VIII-B; 9356; CSO: I.J.4)

7. (d) Requiring employees to have their direct supervisors approve their time cards would most effectively ensure that payment is made only for work performed. The other answer alternatives are good controls, but they are not as effective for this purpose. In most cases, the direct supervisor witnesses the actual work performed. Requiring employees to use a time clock improves accuracy and validity of amounts recorded. Having a payroll clerk recalculate the time cards also improves accuracy. Requiring employees to sign their time cards allows verification of employee existence and improves accuracy. (Chapter 25-III-G; 9357; CSO: II.F.0)

8. (b) The degree to which information technology (IT) is used in the accounting function is most likely to affect the extent of the documentation of the auditor's understanding of a client's system of internal control. The form and extent of documentation are influenced by the nature, size, and complexity of the entity and its

environment, including its internal control, and the availability of information from the entity and the specific audit methodology and technology used in the course of the audit. An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. The use of IT also affects the fundamental manner in which transactions are initiated, authorized, recorded, processed, and reported. And an entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT. Documentation of the understanding of a complex information system in which a large volume of transactions are electronically initiated, authorized, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system making limited or no use of IT or for which few transactions are processed, documentation in the form of a memorandum may be sufficient. The effect on the internal control system of an entity of the other answer alternatives is not as pervasive, thus their impact on the extent of the documentation of the auditor's understanding of it is less. (Chapter 23-II-D; 9358; CSO: II.C.0)

9. (a) In considering whether the report issued by Blue, a service auditor, is satisfactory, Green should make inquiries concerning Blue's professional reputation. The question does not give enough information to determine if Green should assess control risk at the maximum level and it is not relevant to the consideration of whether the service auditor's report is satisfactory for the user auditor's purposes. Green would perform tests of controls at the service organization to obtain audit evidence of the operating effectiveness of relevant controls that would allow Green to assess control risk—the service auditor's report does not provide such evidence; it helps in providing a sufficient understanding of the controls of the service organization. Green might review the audit programs followed by Blue to gain a better understanding of the controls of the service organization, but the guidance specifically directs the user auditor to consider the professional reputation of the service auditor for the determination of whether the report is satisfactory. (Chapter 30-IV-C; 9359; CSO: II.E.0)

10. (c) An auditor interviewing and observing appropriate personnel to determine segregation of duties is considered a test of controls. Reviewing the check register for unrecorded liabilities and evaluating a journal entry are examples of tests of details of classes of transactions, account balances—substantive procedures. Reviewing the audit workpapers is an example of a quality control procedure performed by an audit firm to ensure the quality of its engagement performance—tests of controls refer to tests of the client's internal control system. (Chapter 24-I-D; 9360; CSO: II.F.0)

11. (a) When planning a particular sample for a substantive test of details, such as subsequent cash receipts, the auditor should consider (1) the relationship of the sample to the relevant audit objective; (2) *preliminary judgments about materiality levels*; (3) the auditor's allowable risk of incorrect acceptance; and (4) characteristics of the population, that is, the items comprising the account balance or class of transactions of interest. The amount of bad debt write-offs from the prior year would not be appropriate to consider to detect information about subsequent cash receipts. The size of the intercompany receivable balance is not related to subsequent cash receipts. The risk of assessing control risk too low (the risk that the assessed level of control risk based on the sample is less than the true operating effectiveness of the control) relates to sampling risk in performing tests of controls rather than a substantive test of details as described in this question. (Chapter 26-I-G; 9361; CSO: III.A.1)

12. (a) A lower than expected return on an equity method investment most likely could have been caused by an error in recording amortization of the excess of the investor's cost over the investment's underlying book value. The investee's decision to reduce cash dividends would increase the expected carrying amount of the investment under the equity method. Marketable securities (available-for-sale or trading securities) are not accounted for using the equity method. A fluctuation in the market price of the investee's common stock would not affect investments accounted for using the equity method. (Chapter 24-IV-C; 9362; CSO: III.A.2)

13. (d) When well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, an auditor's observation procedures for inventory may be performed either during or after the end of the period under audit. When a client maintains periodic inventory records, the physical count required is normally made at the balance sheet date or very close to it. Minimal variation in client records and test counts in prior periods or lack of significant variation in the last five years are not sufficient justification for leaving the observation of inventories to after the end of the period under audit. (Chapter 25-III-C; 9363; CSO: III.A.4)

14. (d) A parallel simulation is a computer-assisted audit technique that permits an auditor to insert the auditor's version of a client's program to process data and compare the output with the client's output. (Chapter 27-V-B; 9364; CSO: III.A.6)

15. (c) An auditor's primary method to corroborate information on litigation, claims, and assessments is to review the response from the client's lawyer to a letter of audit inquiry. Verifying attorney-client privilege would not provide information about litigation, claims, and assessments. Examining legal invoices does not provide as much evidence about the substance (nature) of the litigation, claims, and assessments as the attorney's letter. Reviewing management's written representations is an incorrect response because management cannot corroborate its own information. (Chapter 24-VI-B; 9365; CSO: III.C.0)

16. (a) That management has the responsibility for the design of controls to detect fraud is a role that would typically be acknowledged in a management representation letter. None of the other answer alternatives would typically be included. (Chapter 24-III-B; 9366; CSO: III.E.0)

17. (d) Before reissuing a compilation (or review) report on the financial statements of a nonissuer for the prior year, the predecessor accountant is required to (1) read the financial statements of the current period and the successor's report; (2) *compare the prior period financial statements* with those previously issued *and with those of the current period*; and (3) obtain a letter from the successor that indicates whether the successor is aware of any matter that might have a material effect on the financial statements, including disclosures, reported on by the predecessor—the predecessor should not refer in the reissued report to this letter or to the report of the successor. In a compilation engagement the accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity. The predecessor is not required to review the successor's working papers for matters affecting the prior year—the predecessor may rely on a review of the financial statements of the current period and the successor's report as well as the letter from the successor just described in (3) to identify any matters affecting the prior year. The predecessor is not required to verify that the reissued report will not be used to obtain credit from a financial institution. (Chapter 31-II-D; 9367; CSO: V.A.2)

18. (b) When reviewing the financial statements of a nonissuer in accordance with the SSARS, a CPA would ordinarily compare the financial statements with budgets or forecasts. A review does not contemplate obtaining an understanding of the entity's internal control or assessing control risk; assessing fraud risk; tests of accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents or other procedures ordinarily performed in an audit. (Chapter 31-I-C; 9368; CSO: III.H.0)

19. (b) Evidence obtained from independent sources outside an entity provides the highest level of assurance. Evidence obtained from independent sources outside an entity provides greater assurance about the subject matter or the assertion than evidence secured solely from within the entity even if it is obtained from multiple inquiries. Information obtained from the independent attester's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly. (Chapter 31-III-D; 9369; CSO: I.A.3)

20. (b) When an auditor is supplied with copies of vendor invoices instead of originals and told the originals have been misplaced, the auditor should *reevaluate the risk of fraud and design alternate tests for the related transactions*. Audit procedures that are appropriate to the particular audit objective should be applied to each sample item. If considering those unexamined items [the originals] to be misstated would lead to a conclusion that the balance or class contains material misstatement, the auditor should consider alternative audit procedures that would provide sufficient appropriate audit evidence to form a conclusion. The auditor should also consider whether the reasons for the lack of availability of the items have implications in relation to assessing risks of material misstatement due to fraud, the assessed level of control risk that the auditor expects to be supported, or the degree of reliance on management representations. (Chapter 26-I-G; 9370; CSO: III.A.1)

21. (a) If a client prefers not to correct several errors in the financial statements that are not material in the aggregate, the auditor should document the errors in the summary of uncorrected errors, and document the conclusion that the errors do not cause the financial statements to be misstated. (Chapter 22-II-H; 9371; CSO: IV.C.0)

22. (b) When qualifying an opinion because of an insufficiency of audit evidence, an auditor should refer to the situation in the scope paragraph. Restrictions on the scope of the audit such as the inability to obtain sufficient appropriate audit evidence may require the auditor to qualify the opinion or to disclaim an opinion. When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of audit evidence, the situation should be described in an explanatory paragraph preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, because the description of the audit scope is the auditor's responsibility, not the client's. (Chapter 28-IV-A; 9372; CSO: V.A.1)

23. (d) If an accountant compiles the financial statements of a nonissuer in accordance with SSARS for a client with which the accountant has an ownership interest, the accountant should include the statement "I am not independent with respect to the entity." in the compilation report. An accountant is not precluded from issuing a report with respect to a compilation of financial statements for an entity with respect to which the accountant is not independent. The accountant is also not precluded from disclosing a description about the reason(s) that independence is impaired. (Chapter 31-I-B; 9373; CSO: V.A.2)

24. (b) When reporting on compliance with laws and regulations in a financial audit under *Government Auditing Standards* (the "Yellow Book"), in some circumstances, auditors are required to report fraud and illegal acts directly to parties external to the audited entity. Auditors should report known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse directly to parties outside the audited entity in the following two circumstances: (1) when entity management and those charged with governance fail to report such information to external parties specified in law or regulation or (2) when entity management or those charged with governance fail to take timely and appropriate steps to respond to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that (a) is likely to have a material effect on the financial statements and (b) involves funding received directly or indirectly from a government agency. In the later case, the auditors should report the entity's failure directly to the funding agency. Auditors should include relevant information about fraud, illegal acts or other material noncompliance in the audit report. The auditor's key findings of the audit should not be communicated in a separate report. Generally accepted government auditing standards establish reporting standards for financial audits in addition to (rather than modify) the auditor's responsibilities under GAAS. (Chapter 29-I-B; 9374; CSO: V.A.3)

25. (c) Reports are considered special reports when issued in conjunction with compliance with aspects of regulatory requirements related to audited financial statements (AU 623, *Special Reports*). Interim financial information reviewed to determine whether material modifications should be made to conform with GAAP are review reports (AR 100, *Compilation and Review of Financial Statements* or AU 722, *Interim Financial Information*). Reports on feasibility studies could be examination or compilation reports, or reports on results of applying agreed-upon procedures (AT 301, *Financial Forecasts and Projections*). Reports on *pro forma* financial presentations designed to demonstrate the effects of hypothetical transactions can be either examination or review reports (AT 401, *Reporting on Pro forma Financial Information*). (Chapter 30-II-D; 9375; CSO: V.A.4)

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## Solution 2 ADDITIONAL MULTIPLE-CHOICE ANSWERS

26. (b) An accountant is required to comply with the provisions of SSARS when compiling financial statements generated through the use of computer software. The accountant should not submit unaudited financial statements of a nonissuer to a client or a third party unless, as a minimum, the accountant complies with the provisions of the SSARS applicable to a compilation engagement. *Submission of financial statements* is defined as presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software. Reproducing client-prepared financial statements, without modification, for the client is not considered a submission of financial statements to a client. (Chapter 31-I-A; 9376; CSO: I.A.3)

27. (d) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, defines a sub-recipient as a nonfederal entity that expends federal awards received from another entity to carry out a federal program. (Chapter 29-I-C; 9377; CSO: I.A.4)

28. (b) A likely benefit of IT used for internal control is *enhanced timeliness*, availability, and accuracy of *information*. Processing of large, unusual, or nonrecurring transactions is an example of a circumstance where manual controls of systems may be more suitable. Potential loss of data or inability to access data as required as well as recording of unauthorized or nonexistent transactions or inaccurate recording of transactions are examples of specific risks that IT poses to an entity's internal control. (Chapter 27-II-D; 9378; CSO: II.A.0)

29. (c) Analytical procedures are most appropriate when testing operating expense transactions. Relationships involving income statement accounts tend to be more predictable than relationships involving only balance sheet accounts because income statement accounts represent transactions over a period of time, whereas balance sheet accounts represent amounts as of a point in time. (Chapter 24-IV-D ;9379; CSO: III.A.2)

30. (c) The auditor should consider withdrawing from the audit engagement and disassociating from future relationships with the client when the client does not take the remedial action that the auditor considers necessary even when the illegal act is not material to the financial statements. Adding an explanatory paragraph to a standard report is not an option when an illegal act has occurred and a client refuses to take remedial action. A qualified or adverse opinion would be in order if the effect on the financial statements was material and the act had not been accounted for or disclosed properly—the questions states that the amounts were immaterial to the financial statements. Disclosure of an illegal act to parties other than the client's senior management and those charged with governance is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects the opinion on the financial statements. However, in the following circumstances a duty to notify parties outside the client may exist: (1) when the entity reports an auditor change under the appropriate securities law on Form 8-K; (2) to a successor auditor when the successor makes inquiries in accordance with AU 315, *Communications Between Predecessor and Successor Auditors*; (3) in response to a subpoena; or (4) to a funding agency or other specified agency in accordance with requirements for the audits of entities that receive financial assistance from a government agency. The question does not indicate that any of these special circumstances exist; further, no guidance exists that calls for reporting to officials at least one level above persons who received the bribe. (Chapter 22-VIII-F; 9380; CSO: V.B.2)

31. (d) Performing cutoff procedures for shipping and receiving would be the best test for the completeness assertion as it applies to inventory. The completeness assertion means that all transactions that should have been recorded have been recorded. Many procedures test multiple assertions, so candidates must select the best answer—some of the other answer alternatives are better tests of other assertions. Scanning perpetual inventory, production, and purchasing records tests accuracy. Examining paid vendor invoices tests accuracy and occurrence. Tracing inventory items from the tag listing back to the physical inventory quantities tests accuracy and existence. (Chapter 25-III-C; 9381; CSO: III.A.5)

32. (d) Having the department supervisor approve a summary of hours each employee worked during the pay period would be most likely to help in the prevention or detection of a payroll fraud. The other answer alternatives are examples of improper segregation of duties. (Chapter 23-I-B ;9382; CSO: II.B.0)

33. (b) Verifying that approved spending limits are not exceeded would best assess the validity of the auditor's concern about a policy of management override because It is management's responsibility to authorize expenditures. Irregularities which might be discovered by matching purchase orders to accounts payable or tracing sales orders to revenue accounts might not involve management. Undetected management override of controls would not be described in minutes of board meetings. (Chapter 23-II-A; 9383; CSO: II.D.0)

34. (a) When an auditor plans to rely on controls that have changed since they were last tested, the auditor should test the operating effectiveness of such controls in the current audit. Changes may affect the relevance of the audit evidence obtained in prior periods, thus it may no longer be a basis for continued reliance. (Chapter 23-III-C; 9384; CSO: II.F.0)

35. (d) An auditor would expect to find that an entity implemented automated controls to reduce risks of misstatement *when transactions are high-volume and recurring*; in situations where errors can be anticipated or predicted; or for control activities where the specific ways to perform the control can be adequately designed and automated. The other answer alternatives describe circumstances where judgment and discretion are required and thus manual controls of systems may be more suitable. (Chapter 27-II-D; 9385; CSO: II.A.0)

36. (c) Analytical procedures have revealed no unusual or unexpected results is the explanation that best describes why an auditor may decide to reduce tests of details for a particular audit objective. The auditor may determine that performing only substantive analytical procedures may be sufficient to reduce the planned level of detection risk to an acceptably low level. The other answer explanations are not factors. (Chapter 22-VI-B; 9386; CSO: I.L.0)

37. (d) The receipt (acceptance) of electronic confirmations, for example by facsimile or e-mail, is not precluded by GAAS; however, such responses involve risks relating to reliability because proof of origin and knowledge of the respondent may be difficult to establish and alterations may be difficult to detect. In some cases, the auditor may determine that it is appropriate to address the risks related to the reliability of the information received electronically by directly contacting the purported sender. Also, in this case, the auditor received the confirmation indirectly (the client's fax machine) which is a factor that may indicate increased risk. (Chapter 25-III-B; 9387; CSO: III.A.3)

38. (b) Examining vendor statements for amounts not reported as purchases is the test of details that would most likely help an auditor determine whether accounts payable have been misstated. The vendor statements are directly related to amounts that should be recorded as accounts payable. Cash received from customers and customer-returned goods are related to sales and accounts receivable, not accounts payable. The examination of *reported* purchase returns would not reveal evidence of unrecorded purchase returns. (Chapter 25-III-F; 9388; CSO: III.A.5)

39. (b) The most effectively timed audit procedure for revenue would be to inspect transactions occurring in the last month of the fiscal year and review the related sales contracts to determine that revenue was posted in the proper period. Audit procedures should be in synch with the flow of the transactions being tested. This approach will allow the best evidence to be obtained because the most relevant information will be available during the last month, rather than an "interim date." A review of period-end compensation for bonuses paid which are based on revenue is not an audit procedure to test revenue. (Chapter 22-VI-B; 9389; CSO: I.L.0)

40. (c) Subsequent events that provide evidence concerning conditions that did not exist at year-end but arose after year-end may be important to the auditor because they may require disclosure to keep the financial statements from being misleading. Subsequent events that provide evidence concerning conditions that did exist at the balance sheet date require adjustments to the financial statements. (Chapter 28-VII-B; 9390; CSO: III.D.0)

41. (d) Disagreements [between the auditor and management] of the amount of the LIFO inventory layer based on *preliminary* information do not have to be communicated by the auditor to those charged with governance. Disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved. Although the correct answer did not indicate it was later resolved, the other answer alternatives did not indicate that they were based on incomplete or preliminary information. (Chapter 22-VIII-B; 9391; CSO: III.G.0)

42. (a) An accountant reviewing a company's financial statements in accordance with SSARS is required to obtain knowledge of the client's industry. Sending bank confirmations and observing a client's physical inventory are audit procedures which are not required in a review engagement. A signed engagement letter is preferable, but not required for a review engagement. Chapter 31-I-C; 9392; CSO: I.F.0)

43. (c) During an engagement to compile prospective financial statements, an accountant should make inquiries about the accounting principles used in the preparation of the prospective financial statements. The other answer alternatives are not required procedures. (Chapter 31-IV-B; 9393; CSO: III.I.0)

44. (b) When applying analytical procedures during an audit, the best approach for developing expectations is to identify reasonable explanations for unexpected differences before talking to the client management. This allows a more objective approach. Data from unaudited account balances and ratios are less likely to be reliable than data that has been audited. It is nonsensical to consider a pattern of several unusual changes without trying to explain what caused them. Comparing client data with client-determined expected results to reduce detailed tests of account balances is the substitution of the client's judgment for the auditor's judgment which is always inappropriate. (Chapter 24-IV-A.;9394; CSO: III.A.2)

45. (b) Sufficient and appropriate documentation should include evidence that the audit working papers have been reviewed. It should be clear who reviewed specified elements of the audit work performed and when. Accounting estimates are an example of the significant findings or issues that should be documented along with the actions taken to address them and the basis for the final conclusions reached. If additional evidence is required to document significant findings or issues, the original evidence should not be deleted. Audit documentation is the property of the auditor, not the client. Note: The retention period of at least five years from the report release date is correct for nonissuers—it is seven years for issuers. After the documentation completion date, the auditor must not delete or discard audit documentation before the end of the specified retention period; any time prior to this date, the auditor may make changes to delete superseded or incorrect material. (Chapter 24-VII-B; 9395; CSO: IV.B.0)

46. (b) If not already performed during the overall review stage of the audit, the auditor should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. (Chapter 22-IV-B; 9396; CSO: IV.C.0)

47. (a) An accountant who is not independent may perform compilations, but not reviews. (Chapter 31-I-B; 9397; CSO: I.A.2)

48. (a) If the owner of a company is the accountant's father, the accountant would be precluded from issuing a review report on a company's financial statements in accordance with SSARS because independence is required. The other answer alternatives would not preclude an accountant from performing a review. Note: The accountant engaged to review only the balance sheet may do so if the scope of the accountant's inquiry and analytical procedures has not been restricted. (Chapter 31-I-C; 9398; CSO: I.A.2)

49. (a) A list of the procedures performed (or reference thereto) and related findings is an appropriate component of a practitioner's report on the results of applying agreed-upon procedures. Neither management nor the practitioner is responsible for expressing an opinion. The report includes a disclaimer of opinion on the subject matter. An appropriate title for the report is *Independent Accountant's Report on Applying Agreed-Upon Procedures*; it would not include the term *audit*. The report should include a statement of restrictions on the use of the report because it is intended to be used solely by the specified parties, not a statement that it is unrestricted in its use. (Chapter 31-IV-A; 9399; CSO: V.A.7)

50. (b) The auditor's report on condensed financial statements that are derived from financial statements that the CPA has audited should indicate (1) that the auditor has audited and expressed an opinion on the complete financial statements; (2) the date of the auditor's report on the complete financial statements; (3) the type of opinion expressed; and (4) *whether, in the auditor's opinion, the information set forth in the condensed financial statements is fairly stated in all material respects in relation to the complete financial statements from which it has been derived*. A qualified opinion on the complete set of audited financial statements is not required. The condensed financial statements will not include all the disclosures necessary for the complete set of financial statements. For this reason, they should be read in conjunction with the entity's most recent complete financial statements. A comparative presentation is not required. (Chapter 30-VI-A; 9400; CSO: V.A.4)

**Solution 3 SIMULATION ANSWER****Response #1: Analytics**

Ratios:

Earnings per Share  $\frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Average Number of Common Shares Outstanding}}$

Days Sales in Accounts Receivable  $\frac{\text{Net Accounts Receivable}}{\text{Net Sales} / 360}$

Gross Profit  $\text{Net Sales} - \text{Cost of Sales}$

## 1. Earnings per Share: Increase

The increase in sales increased net income so earnings per share would increase.

Days Sales in Accounts Receivable: Increase

Accounts receivable increased proportionately more than sales per day increased so days sales in accounts receivable would increase.

Gross Profit: Increase

Sales increased more than the cost of sales so the gross profit would increase.

## 2. Earnings per Share: Decrease

The increase in expense decreased net income so earnings per share would decrease.

Days Sales in Accounts Receivable: Decrease

Accounts receivable did not change and sales per day increased so days sales in accounts receivable would decrease.

Gross Profit: No impact

Sales and cost of sales increased by the same amount so there was no change in the gross profit.

## 3. Earnings per Share: Decrease

The increase in taxes decreased net income so earnings per share would decrease.

Days Sales in Accounts Receivable: No impact

The accounts that changed are not used in the calculation of this ratio.

Gross Profit: No impact

The accounts that changed are not used in the calculation of this ratio.

**Response #2: Audit Procedures**

1. Inspection

2. Observation

3. Inspection

4. Inquiry
5. Recalculation
6. Reperformance
7. Analytical

**Response #3: Attorney Letters**

1. Audit Response (Financials): No impact on financial statements or notes to the financial statements  
The attorney reported no activity.  
  
Audit Response (Report): Legal response is appropriately dated  
The date of the attorney's response and the release date of the audit report are only one day apart.
2. Audit Response (Financials): Verify amount due attorney is recorded in financial statements  
The attorney's response included the balance of fees outstanding, but no pending litigation, claims, or assessments.  
  
Audit Response (Report): Update legal response  
The date of the attorney's response (January 21, year 2) is not close enough to the release date of the auditor's report (February 15, year 2).
3. Audit Response (Financials): Disclosure in notes to financial statements relating to nature of litigation, but no amount disclosed  
The attorney described pending litigation whose underlying cause was an event that existed at the date of the financial statements, but is unable to evaluate the likelihood of an unfavorable outcome or estimate the amount or range of the potential loss.  
  
Audit Response (Report): Update report date  
The attorney's response is dated after the release date of the auditor's report, thus the report would need to be updated.
4. Audit Response (Financials): Disclosure in notes to financial statements relating to nature of litigation, but no amount disclosed  
The attorney described pending litigation whose underlying cause was an event that existed at the date of the financial statements, but is unable to evaluate the likelihood of an unfavorable outcome.  
  
Audit Response (Report): Update report date  
The attorney's response is dated after the release date of the auditor's report, thus the report would need to be updated.
5. Audit Response (Financials): Potential litigation settlement not accrued in financial statements, amount disclosed in notes to financial statements  
The attorney's response described a tentative settlement of a claim (covered by the XYZ Company's insurance carrier) whose underlying cause was an event that existed at the date of the financial statements.

Audit Response (Report): Update legal response

The date of the attorney's response (January 10, year 2) is not close enough to the release date of the auditor's report (February 15, year 2).

6. Audit Response (Financials): Potential litigation settlement accrued in financial statements

The attorney's response described a tentative settlement of a claim whose underlying cause was an event that existed at the date of the financial statements.

Audit Response (Report): Update legal response

The date of the attorney's response (January 20, year 2) is not close enough to the release date of the auditor's report (February 15, year 2).

#### Response #4: Communication

To: Audit Engagement Partner

From: Audit Engagement Manager

Re: Possible Fraudulent Activities

We have encountered some accounting anomalies during our audit which may indicate fraudulent activity. We were unable to locate vendor invoices for several purchase transactions. As you know, missing supporting documentation is an indicator of possible fraud and this case was of particular concern because all the missing invoices were for the same vendor. We are in the process of obtaining evidence that the vendor exists and if so, confirmation that the purchases were legitimate and not inflated. Our further audit procedures for this matter revealed that checks issued for these same transactions had second endorsements. Naturally this heightened our suspicion of fraud. We will be investigating the identity of the check endorsers and will keep you apprised of our progress and findings.

#### Response #5: Research

Paragraph Reference Answer: AU 336.16

"The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to his or her standard report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion."

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