AUDITING & ATTESTATION

CPA2902US2-40

TABLE OF CONTENTS

We wish to thank the American Institute of Certified Public Accountants and other organizations for permission to reprint or adapt the following copyrighted © materials:

1. Uniform CPA Examination Questions and Unofficial Answers, Copyright by American Institute of Certified Public Accountants, Inc. All rights reserved. Reprinted with permission.
2. Audit and Accounting Guides, Auditing Procedure Studies, Risk Alerts, Statements of Position, and Code of Professional Conduct, Copyright by American Institute of Certified Public Accountants, Inc. All rights reserved. Reprinted with permission.
3. *The FASB Accounting Standards Codification*™ and Statements of Financial Accounting Concepts, Copyright by the Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856, are reprinted with permission.
4. GASB Statements, Interpretations, and Technical Bulletins, Copyright © Governmental Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116
5. Statements on Auditing Standards, Statements on Standards for Consulting Services, Statements on Responsibilities in Personal Financial Planning Practice, Statements on Standards for Accounting and Review Services, Statements on Quality Control Standards, Statements on Standards for Attestation Engagements, and Statements on Responsibilities in Tax Practice, Copyright by American Institute of Certified Public Accountants, Inc. All rights reserved. Reprinted with permission.
6. ISB Standards, Copyright © Independence Standards Board, 6th Floor, 1211 Avenue of the Americas, New York, NY 10036-8775
7. International Standards on Auditing and *Code of Ethics for Professional Accountants*, Copyright © April 2010 by the International Federation of Accountants (IFAC). All rights reserved. Used with permission of IFAC, 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA

About Updating Supplement Version 40.2

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 In this case, *both* the previous and the new pronouncements can be tested until the previous pronouncement has been superseded.

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 2011 and later exam windows. Candidates using our 40th edition textbook or the corresponding version 14 series software will find the information in this supplement more than adequate for these exam windows.

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.

**Purchase of software required. Call for complete details. (1-800-404-7231)*

Previous Editions and Updating Supplements

Beginning with the January-February 2011 exam window, the AICPA has established new content specification outlines. Due to significant changes in the topics eligible to be tested, the Bisk Education editors strongly encourage candidates with the Comprehensive CPA Exam Review, 39th edition, and/or the corresponding version 13 series software—or earlier materials—to obtain the 40th edition book and/or the corresponding version 14 series software. Please contact a customer service representative at 1-800-280-9718.

Candidates choosing to use previous editions of our books must accept responsibility for adequately updating their materials. Candidates should consider the strain that this will add to the already time-consuming process of studying for the exam. Material in the related updating supplements may be reviewed to determine the nature and quantity of information that has changed from one edition to another.

AUD CSO/SSO Reference List Updated

Effective July 1, 2011, the AICPA updated the list of references that appear at the end of the content and skill specification outline (CSO/SSO) for the AUD exam to include International Standards on Auditing (ISA). This is **not** a change to the technical content and weight allocations outlined in the CSO—knowledge of the differences between ISA and U.S. auditing standards was already included in the AUD CSO/SSO.

Recent Pronouncements

PCAOB AS 8 through 15, *Risk Assessment Standards*; approved by the SEC 12/2010

The standards will be eligible to be tested beginning with the July-August 2011 exam window. In December 2010 the Securities and Exchange Commission approved the Public Company Accounting Oversight Board (PCAOB) Auditing Standards (AS) 8 through 15, *Risk Assessment Standards*, listed below. The new standards are effective for audits of fiscal years beginning on or after December 15, 2010.

- PCAOB AS 8, *Audit Risk*
- PCAOB AS 9, *Audit Planning*
- PCAOB AS 10, *Supervision of the Audit Engagement*
- PCAOB AS 11, *Consideration of Materiality in Planning and Performing an Audit*
- PCAOB AS 12, *Identifying and Assessing Risks of Material Misstatement*
- PCAOB AS 13, *The Auditor's Responses to the Risks of Material Misstatement*
- PCAOB AS 14, *Evaluating Audit Results*
- PCAOB AS 15, *Audit Evidence*

These new standards supersede the PCAOB's adopted interim standards listed below:

- AU 311, *Planning and Supervision*
- AU 312, *Audit Risk and Materiality in Conducting an Audit*
- AU 313, *Substantive Tests Prior to the Balance Sheet Date*
- AU 319, *Consideration of Internal Control in a Financial Statement Audit*
- AU 326, *Evidential Matter*
- AU 431, *Adequacy of Disclosure in Financial Statements*

The auditor's assessment of and response to risks underlies the entire audit process. The new standards benefit investors by updating (improving) the requirements for assessing and responding to the risks of material misstatement in an audit—the underlying concepts of risk-based auditing have not changed.

Key changes made to the requirements in the PCAOB's adopted interim standards include:

- An increased emphasis on fraud risks to make clear that assessing and responding to fraud risks is an integral part of the audit process rather than a parallel, separate process;

- An increased emphasis on disclosures;

- Inclusion of multilocation audit requirements;

- An alignment of the standards with PCAOB AS 5*, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*; and

- Inclusion of a concept of materiality more specifically grounded to that used in the federal securities laws.

A brief description of each PCAOB risk assessment standard follows with the substantive differences, if any, between the three sets of audit standards—PCAOB audit standards, SAS, and ISA—outlined.

PCAOB AS 8, *Audit Risk*

This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance that the financial statements are free of material misstatement.

Inverse Relationship of Detection Risk & Substantive Procedures PCAOB standards include an explicit requirement that as the appropriate level of detection risk decreases, the evidence from substantive procedures that the auditor should obtain increases. SAS and ISA include a discussion about the inverse relationship and guidance that the auditor can act accordingly. Put another way, SAS and ISA include an implicit rather than an explicit requirement regarding this matter because risk assessment is required and its purpose is to allow auditors to vary the amount of audit attention related to particular areas based on the risks presented by them.

Editor note: Detection risk relates to the substantive audit procedures and is managed by the auditor's response to the risk of material misstatement (RMM). As the assessed RMM increases, the evidence from substantive procedures that the auditor should obtain also increases. The auditor reduces detection risk through the nature, extent, and timing of substantive procedures performed. However, the auditor should perform substantive procedures for all relevant assertions related to material classes of transactions, account balances, and disclosures.

PCAOB AS 9, *Audit Planning*

This standard establishes requirements regarding planning an audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan.

Development of the Audit Strategy & Audit Plan PCAOB standards include a requirement to evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures. These matters were adapted from PCAOB AS 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

- Knowledge of the company's internal control over financial reporting obtained during other engagements performed by the auditor;
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality, risk, and, in integrated audits, other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;
- Preliminary judgments about the effectiveness of internal control over financial reporting;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;

- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and

- The relative complexity of the company's operations.

SAS and ISA advise the auditor to consider similar matters with less emphasis on internal control.

Documentation of the Audit Plan & Audit Strategy PCAOB standards do not include the phrase *at the relevant assertion level for each material class of transactions, account balance, and disclosure* when describing the documentation requirements for audit procedures as do SAS and ISA. This is not a difference between the standards regarding documentation of audit procedures. SAS and ISA use the phrase to indicate the coverage / level of detail while the PCAOB omits it for clarity reasons because not all audit procedures relate to the assertion level, i.e., some are performed at the entity level.

Multilocation Engagements PCAOB standards state that the auditor should determine the extent to which auditing procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, extent, and timing of the audit procedures to be performed at those individual locations or business units. The auditor should assess the RMM to the consolidated financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

Factors that are relevant to the assessment of the RMM associated with a particular location or business unit and the determination of the necessary audit procedures include:

- The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions executed at the location or business unit that are outside the normal course of business for the company, or that otherwise appear to be unusual given the auditor's understanding of the company and its environment;

- The materiality of the location or business unit;

- The specific risks associated with the location or business unit that present a reasonable possibility of material misstatement to the company's consolidated financial statements;

- Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;

- The degree of centralization of records or information processing;

- The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and

- The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.

SAS advise consideration of different locations and business components when establishing the scope of an audit, but do not include a detailed discussion like the PCAOB standards.

ISA address some of the same aspects of this matter in a separate standard on audits of group financial statements (including the work of component auditors) mainly in relation to the impact on the scope of the audit. The focus in ISA is on the determination of whether a component is significant (mainly based on materiality) and, if so, the applicable audit procedures. Risk assessment is an important factor but not to the degree or specificity as described in the PCAOB approach.

PCAOB AS 10, *Supervision of the Audit Engagement*

This standard sets forth requirements for supervision of the audit engagement, including, in particular, supervising the work of engagement team members. It applies to the engagement partner and to other engagement team members who assist the engagement partner with supervision.

Supervision by Other Engagement Team Members PCAOB standards state that the engagement partners may seek assistance from appropriate engagement team members in fulfilling their responsibilities. SAS and ISA mention delegation of review responsibilities only.

Extent of Supervision Needed Factors Per PCAOB standards, to determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account:

- The nature of the company, including its size and complexity;
- The nature of the assigned work for each engagement team member, including the procedures to be performed, and the controls or accounts and disclosures to be tested;
- The risks of material misstatement; and
- The knowledge, skill, and ability of each engagement team member.

ISA list essentially the same factors. SAS explain that many factors are involved in determining the extent of the supervision that is appropriate and give two examples: the complexity of the subject matter and the qualifications of the persons performing the work, including knowledge of the client's business and industry.

PCAOB AS 11, *Consideration of Materiality in Planning and Performing an Audit*

This standard describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.

Materiality for Financial Statements as a Whole PCAOB standards require the auditor to establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances, including consideration of the company's earnings and other relevant factors.

SAS and ISA have essentially the same requirement. SAS and ISA state that the determination of what is material to the users is a matter of professional judgment. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole. To identify an appropriate benchmark, factors, for example, earnings should be considered.

Definition of Materiality The PCAOB's requirement for establishing a materiality level for the financial statements as a whole is based on the concept of materiality that is articulated by the courts in interpreting the federal securities laws. In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "a substantial likelihood that the …fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him. The SAS requirement is based on the definition of materiality similarly articulated by the FASB: "…the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

Tolerable Misstatement PCAOB standards contain a requirement to take into account the nature, cause (if known), and amount of misstatements that were accumulated in audits of the financial statements of prior periods when determining tolerable misstatement and planning and performing audit procedures. SAS and ISA do not have such a requirement.

Editor note: *Tolerable misstatement* is the maximum error in a population (for example, the class of transactions, account balance, or disclosure) that the auditor is willing to accept. When assessing the risks of material misstatements and designing and performing further audit procedures to respond to the assessed risks, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements.

PCAOB AS 12, *Identifying and Assessing Risks of Material Misstatement*

This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. The risk assessment process discussed in the standard includes information-gathering procedures to identify risks and an analysis of the identified risks.

Additional Procedures for Obtaining an Understanding PCAOB standards require the auditor to consider performing certain procedures as part of obtaining an understanding of the company. These procedures include reading public information about the company, observing or reading transcripts of earnings calls, obtaining an understanding of compensation arrangements with senior management, and obtaining information about trading activity in the company's securities and holdings in the company's securities by significant holders. With the exception of the first item, SAS and ISA do not have such a requirement.

Disclosures PCAOB standards require the auditor to develop expectations about the disclosures that are necessary for the company's financial statements to be presented fairly in conformity with the applicable financial reporting framework to identify and assess the risks of material misstatement related to omitted, incomplete, or inaccurate disclosures. Additionally, the engagement team members should discuss how fraud might be perpetrated or concealed by omitting or presenting incomplete or inaccurate disclosures. The auditor's evaluation of fraud risk factors should include how fraud could be perpetrated or concealed by presenting incomplete or inaccurate disclosures or by omitting disclosures that are necessary for the financial statements to be presented fairly in conformity with the applicable financial reporting framework. Although consideration of appropriate disclosure is included throughout the SAS and ISA, they do not include a requirement similar to this for disclosures.

Control Deficiencies Identified PCAOB standards state that if the auditor identifies a control deficiency in the company's control environment, the auditor should evaluate the extent to which this control deficiency is indicative of a fraud risk factor. SAS and ISA do not have such a requirement.

Relationship of Understanding of Internal Control to Tests of Controls PCAOB standards require the auditor to take into account the evidence obtained from understanding internal control when assessing control risk and, in the audit of internal control, forming conclusions about the effectiveness of controls. The auditor should also take into account the evidence obtained from understanding internal control when determining the nature, extent, and timing of procedures necessary to support the auditor's conclusions about the effectiveness of entity-level controls in the audit of internal control. SAS and ISA do not have such a requirement linking tests of controls to the audit of internal control.

Review of Interim Financial Information When the auditor has performed a review of interim financial information in accordance with AU 722, *Interim Financial Information,* PCAOB standards require the auditor to evaluate whether information obtained during the review is relevant to identifying risks of material misstatement in the year-end audit. SAS and ISA do not have such a requirement.

Analytical Procedures Per PCAOB standards, when the auditor has performed a review of interim financial information in accordance with AU 722, *Interim Financial Information*, the auditor should take into account the analytical procedures applied in that review when designing and applying analytical procedures as risk assessment procedures. SAS and ISA do not have such a requirement.

Discussion Among Engagement Team Per PCAOB standards, communication among the engagement team members about significant matters affecting the risks of material misstatement should continue throughout the audit, including when conditions change. SAS and ISA do not have such a requirement to continue the discussion throughout the audit. SAS state that depending on the circumstances of the audit, there *may* be multiple discussions in order to facilitate the ongoing exchange of information between audit team members regarding the susceptibility of the entity's financial statements to material misstatements. The purpose is for audit team members to communicate and share information obtained throughout the audit that may affect the assessment of the risks of material misstatement due to fraud or error or the audit procedures performed to address the risks.

PCAOB AS 13, *The Auditor's Responses to the Risks of Material Misstatement*

This standard establishes requirements for responding to the risks of material misstatement in financial statements through the general conduct of the audit and performing audit procedures regarding significant accounts and disclosures.

Determination of Need for Pervasive Changes PCAOB standards require the auditor to determine whether it is necessary to make pervasive changes to the nature, timing, or extent of audit procedures to adequately address the assessed risks of material misstatement. Examples of such pervasive changes include modifying the audit strategy to:

- Increase the substantive testing of the valuation of numerous significant accounts at year-end because of significantly deteriorating market conditions, and
- Obtain more persuasive audit evidence from substantive procedures due to the identification of pervasive weaknesses in the company's control environment.

SAS and ISA require the adjustment of the audit strategy and plan to changes in circumstances which would cover the events described above, but they do not have this specific requirement.

More Persuasive Evidence Required PCAOB standards require the auditor to obtain more persuasive evidence about the effectiveness of controls for each relevant assertion for which the audit approach consists primarily of tests of controls. SAS and ISA do not have such a requirement.

Evaluating Operating Effectiveness of Controls PCAOB standards and SAS require the auditor to determine whether the person performing the control possesses the necessary authority and competence to perform the control effectively. ISA do not have such a requirement.

Tests of Controls in an Integrated Audit PCAOB standards require the auditor to perform tests of controls in integrated audits to meet the objectives of both the audit of financial statements and the audit of internal control. SAS and ISA do not have such a requirement.

Testing of Controls That Have Not Changed When the auditor is relying on controls, SAS and ISA allow the testing of the operating effectiveness of controls that have not changed to be performed at least every third annual audit. PCAOB standards require the auditor to test controls during the period of reliance, i.e., the period covered by the financial statements or the portion of that period for which the auditor plans to rely on them in order to modify the nature, extent, and timing of substantive procedures—they do **not** allow rotational testing.

Assessment of Control Risk PCAOB standards require the assessment of control risk. SAS and ISA do not require the separate specific assessment of control risk—how to consider the components of audit risk is left up to the auditor's judgment.

Substantive Procedures PCAOB standards require the auditor to perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk. SAS and ISA have essentially the same requirement; however, they require it regardless of the assessed RMM rather than control risk and require it for each material class of transactions, account balance, and disclosure.

Confirmation Procedures ISA address confirmation procedures in their risk assessment standards, requiring the auditor to consider whether confirmation procedures are to be performed as substantive audit procedures. PCAOB standards and SAS do not specifically address confirmation procedures in their risk assessment standards; however, in their respective standards dedicated to confirmations, an auditor who has not requested confirmations in the examination of accounts receivable is required to document the justification for not doing so.

Interim Substantive Procedures PCAOB standards and SAS list various factors the auditor is required to consider when determining whether to perform substantive procedures at an interim date. ISA do not have such a requirement; however, they do provide a list of similar factors that may influence the auditor's decision.

Substantive Procedures to Cover Remaining Period if Interim Testing Performed All three sets of standards include requirements to cover the remaining period. PCAOB standards require that such procedures include comparing relevant information about the account balance at the interim date with comparable information at the end of the period to identify amounts that appear unusual and investigating such amounts; and performing audit procedures to test the remaining period. SAS and ISA contain essentially the same guidance; however, they use the term *may*, i.e., it is not required.

Dual-Purpose Tests PCAOB standards define a dual-purpose test as a substantive test of a transaction and a test of a control relevant to that transaction that are performed concurrently, e.g., a substantive test of sales transactions performed concurrently with a test of controls over those transactions. PCAOB standards state that when dual-purpose tests are performed, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested. SAS and ISA do not have such a requirement.

PCAOB AS 14, *Evaluating Audit Results*

This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether the auditor has obtained sufficient appropriate audit evidence. The evaluation process set forth in this standard includes, among other things, evaluation of misstatements identified during the audit; the overall presentation of the financial statements, including disclosures; and the potential for management bias in the financial statements.

Analytical Procedures Regarding Revenue All three sets of standards require the auditor to perform analytical procedures relating to revenue; however only the PCAOB standards require them to be performed through the end of the period.

Timely Communication of Accumulated Misstatements All three sets of standards require the auditor to communicate misstatements accumulated during the audit to management and follow up on their correction; however, PCAOB standards do not include a specific requirement for the auditor to request their correction as SAS and ISA do.

Evaluation of Effect of Misstatements on Assessed RMM PCAOB standards require the auditor to evaluate the nature and effects of the individual misstatements accumulated during the audit on the assessed risks of material misstatement. SAS and ISA do not have an explicit requirement to evaluate the effect of accumulated misstatements on risk assessment; however, SAS and ISA do have a requirement for the auditor to consider whether the overall audit strategy and audit plan need to be revised if the nature of identified misstatements and the circumstances of their occurrence are indicative that other misstatements may exist that, when aggregated with identified misstatements, could be material.

Misstatements Indicative of Fraud PCAOB standards and SAS require the auditor to perform procedures to obtain additional audit evidence to determine whether fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report if the auditor believes that a misstatement is or might be intentional, and if the effect on the financial statement cannot be readily determined. ISA have similar requirements; however, they do not explicitly require the auditor to perform audit procedures to obtain additional audit evidence to determine the effect of the misstatement on the financial statements.

Communications Regarding Fraud If the auditor becomes aware of information indicating that fraud or another illegal act has occurred or might have occurred, PCAOB standards require the auditor to determine the auditor's responsibility for communications under their adopted interim standards on (a) fraud and (b) illegal acts by clients; and federal securities laws and regulations. The auditor is required, whenever the auditor has determined that there is evidence that fraud may exist, to bring the matter to the attention of an appropriate level of management. SAS and ISA have essentially the same requirement for communication with management and those charged with governance. As for communication outside the entity, their guidance requires the auditor to determine when the auditor should communicate. The SAS state that the auditor may wish to consult with legal counsel beforehand.

Adjusting Entries by Management That Offset Accumulated Misstatements If management identifies adjusting entries that offset misstatements accumulated by the auditor, PCAOB standards require the auditor to perform procedures to determine why the misstatements were not identified previously and to evaluate the implications on the integrity of management and the auditor's risk assessments, including fraud risk assessments. The auditor should also perform additional procedures as necessary to address the risk of further undetected misstatements. SAS and ISA do not have such a requirement.

PCAOB AS 15, *Audit Evidence*

This standard explains what constitutes audit evidence and establishes requirements for designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.

There are no substantive differences between the three sets of standards regarding audit evidence.

SSARS 19, *Compilation and Review Engagements*, (AR 60, *Framework for Performing and Reporting on Compilation and Review Engagements;* AR 80, *Compilation of Financial Statements*; AR 90, *Review of Financial Statements*); issued 12/2009

This statement will be eligible to be tested beginning in the July-August 2011 exam window. In December 2009 the Accounting and Review Services Committee of the American Institute of Certified Public Accountants (AICPA) issued Statement on Standards for Accounting and Review Services (SSARS) 19. SSARS 19 is effective for compilations and reviews of financial statements of nonissuers for periods ending on or after December 15, 2010.

This standard supersedes 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*.

In addition to this updating supplement, this new standard is covered in the text that displays within our online courses and 14.2 and later versions of our software in Chapter 31. Our 40th edition textbook covers the former guidance in the first two sections of Chapter 31.

I. Compilation & Review Engagements for Nonissuers

A. Framework (AR 60)

1. Authoritative Guidance Hierarchy

a. SSARS SSARS are issued by the AICPA and provide performance and reporting guidance for compilations and reviews of unaudited financial statements or other unaudited financial information of nonissuers.

(1) Exception for Certain Interim Reviews There is one exception for certain reviews of interim financial information. When all of the following conditions are met, interim reviews should be performed in accordance with GAAS (AU 722, *Interim Financial Information*) instead of SSARS:

- The entity's latest annual financial statements have been audited;
- The CPA expects to audit the entity's current year financial statements; and
- The same financial reporting framework used to prepare the annual financial statements is used for the interim financial information.

(2) Interim Review Is Extension of Annual Audit When these conditions are met, the review engagement is generally intended to provide a periodic update to the year-end reporting and is considered an extension of the annual audit. Thus, the standard setters decided the guidance should reside in the auditing literature.

b. Interpretative Publications Interpretative publications provide guidance on the application of SSARS. They consist of Interpretations of SSARS; appendices to SSARS; and compilation and review guidance included in AICPA Audit and Accounting Guides and Statements of Position. CPAs should be aware of and consider applicable interpretive publications. Interpretations are recommendations, not standards; however, if a CPA does not apply the applicable interpretative guidance, the CPA should be prepared to justify the departure.

c. Other Publications Other compilation and review publications have no authoritative status. A CPA is **not** expected to be aware of the full body of other publications. A CPA should be satisfied that the guidance is both relevant and appropriate. Other publications include AICPA compilation and review publications not listed above; the AICPA annual *Compilation and Review Alert;* compilation and review articles in the *Journal of Accountancy, The CPA Letter,* and other professional journals; and other instructional materials.

2. Ethical Principles & Quality Control Standards

Ethical Principles & Quality Control Standards In addition to SSARS, AICPA members performing compilation and review engagements are governed by the AICPA's Code of Professional Conduct and Statements on Quality Control Standards.

3. Definitions

a. Financial Reporting Framework A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.

b. **Applicable Financial Reporting Framework** The financial reporting framework adopted by management and used 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. The financial reporting framework encompasses financial accounting standards established by an authorized or recognized standards setting organization.

c. **Submission of Financial Statements** Presenting to management financial statements that a CPA has prepared.

d. **Review Evidence** Information used by a CPA to provide a reasonable basis for obtaining limited assurance.

e. **Third Party** All persons, including those charged with governance, except for members of management.

f. **Professional Requirements** SSARS use two categories of professional requirements, identified by specific terms to describe the degree of responsibility they impose on CPAs—*unconditional requirements and presumptively mandatory requirements*—which have essentially the same meaning as defined in GAAS covered in Chapter 21.

g. **Compilation** Assisting management in presenting financial information in the form of financial statements without undertaking to provide any assurance on the statements.

h. **Review** Obtaining review evidence to provide a limited level of assurance that there are no material modifications that should be made to the financial statements for them to be in conformity with the applicable financial reporting framework.

   (1) **Compilation vs. Review** A compilation does not involve making inquiries or performing analytical or other review procedures. A compilation does not provide any level of assurance. The objective of a review is to provide limited assurance. A CPA need not be independent to perform a compilation; however, the lack of independence must be stated in the report. Independence is required for a review.

   (2) **Review vs. Audit** A review provides only limited assurance that there are no material modifications that should be made to the financial statements for them to be in conformity with the applicable financial reporting framework. An audit provides a high level of assurance (reasonable assurance) that the financial statements are free of material misstatement.

   (3) **Compilation & Review vs. Audit** Neither a review nor a compilation involves obtaining an understanding of internal control, assessing fraud risk, testing accounting records, examining source documents, or other procedures ordinarily performed in an audit.

4. Elements of a Compilation or Review Engagement

a. Three-Party Relationship A compilation or review engagement involves three parties: management (or the responsible party); a CPA; and intended users, who may be from different entities or the same entity. Sometimes management is the intended user.

(1) Management (Responsible Party) Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for internal control. A CPA is precluded from issuing an unmodified compilation or review report unless management accepts these responsibilities. The CPA may make suggestions about the form or content of the financial statements or prepare them, in whole or in part; however this service is based on information that is the representation of management.

(2) CPA A CPA (an accountant in the practice of public accounting) should possess a level of knowledge of the accounting principles and practices of the entity's industry needed to compile or review financial statements that are appropriate in form.

(3) Intended Users The intended users are the person(s) who understand the limitations of the compilation or review engagement and financial statements or financial information. The CPA has no responsibility to identify the intended users. Sometimes intended users (for example, bankers or regulators) will impose additional requirements. The CPA may perform these additional services as long as the CPA adheres to professional standards.

b. Applicable Financial Reporting Framework Management is responsible for the selection of the entity's applicable financial reporting framework, as well as individual accounting policies when the reporting framework contains acceptable alternatives. Examples of financial reporting frameworks include U.S. GAAP as promulgated by the FASB, GASB, or FASAB; IFRS issued by the IASB; and OCBOA.

c. Financial Statements or Financial Information A CPA may be engaged to compile or review a complete set of financial statements or an individual financial statement. The financial statements may be for an annual period or for a shorter or longer period, depending on management's needs. The applicable financial reporting framework determines what constitutes a complete set of financial statements.

d. Evidence When performing a compilation engagement, the CPA has no responsibility to obtain any evidence about the accuracy or completeness of the financial statements. In a review engagement, the CPA should apply professional judgment in determining the specific nature, extent, and timing of review procedures which are deliberately limited relative to an audit. Review evidence obtained through the performance of analytical procedures and inquiries ordinarily will provide the CPA with a reasonable basis for obtaining limited assurance.

e. Written Report Objective The CPA's objective in reporting is to prevent misinterpretation of the degree of responsibility the CPA is assuming when the CPA's name is associated with the financial statements,

5. **Materiality** The concept of materiality is ordinarily addressed by the applicable financial reporting framework. If not, then the CPA should be guided by the following:

   - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;

   - Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both; and

   - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is **not** considered.

   A CPA's determination of materiality is a matter of professional judgment and is affected by the CPA's perception of the financial information needs of users of the financial statements. Appropriate assumptions about users are essentially the same as for GAAS covered in Chapter 22.

B. Compilation of Financial Statements (AR 80)

1. **Applicability** A CPA is required to comply with this guidance whenever the CPA is engaged to report on compiled financial statements or submits financial statements to a client or to third parties.

2. **Objective / Limitation** A compilation is a service, the objective of which is limited to assisting management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

3. **Independence Not Required** Independence is **not** required to perform a compilation engagement; however, the lack of it must be stated in the compilation report. See the reporting section of this topic for more information.

4. **Engagement Letter**

   a. **Establish & Document an Understanding With the Client** The CPA should establish an understanding with the client regarding the services to be performed and should document the understanding through a written communication with management, i.e., an engagement letter.

   b. **Contents** The engagement letter should include the objectives and limitations of the engagement as well as management's and the CPA's responsibilities. Thus, the understanding should address the following items:

      - *The objective of a compilation is to assist management in presenting financial information in the form of financial statements.

      - *The CPA utilizes information that is the representation of management without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

- *Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
- *Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
- Management is responsible for preventing and detecting fraud.
- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- Management is responsible for making all financial records and related information available to the CPA.
- *The CPA is responsible for conducting the engagement in accordance with SSARS issued by the AICPA.
- A compilation differs significantly from a review or an audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures ordinarily performed in an audit. *Accordingly, the CPA will not express an opinion or provide any assurance regarding the financial statements.
- The engagement cannot be relied upon to disclose errors, fraud, or illegal acts.
- The CPA will inform the appropriate level of management of any material errors and of any evidence or information that comes to the CPA's attention during the performance of compilation procedures that fraud or an illegal act may have occurred. The CPA need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.
- The effect of any independence impairments on the expected form of the CPA's compilation report.

*Editor note: These statements or words to the same effect are also included in the CPA's compilation report.

c. **Additional Matters If Applicable** The engagement letter should also address the following additional matters if applicable:

- Material departures from the applicable financial reporting framework may exist, and the effects of those departures, if any, on the financial statements may not be disclosed.
- Substantially all disclosures (and statement of cash flows, if applicable) required by the applicable financial reporting framework may be omitted.

- Reference to supplementary information

d. **Optional Matters** The letter may also include other matters, for example, fees and billings.

e. **If Report Not Issued** If the compiled financial statements are **not** expected to be used by a third party and the CPA does **not** expect to issue a compilation report, the CPA should include in the engagement letter an acknowledgment of management's representation and agreement that the financial statements are not to be used by a third party.

5. **Performance Requirements**

a. **Understanding of the Industry** To compile financial statements that are appropriate in form for a particular industry, a CPA should understand the accounting principles and practices of that industry. A CPA can accept an engagement for an entity in an industry in which the CPA has no previous experience as long as the CPA can acquire the knowledge by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals knowledgeable about the industry.

b. **Knowledge of the Client**

(1) **Business** A CPA should obtain a general understanding of the client's organization; operating characteristics; and the nature of its assets, liabilities, revenues, and expenses. This knowledge is usually acquired through experience with the client or its industry and inquiry of its personnel.

(2) **Accounting Principles & Practices** The CPA should obtain an understanding of the accounting principles and practices used by the client in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. The CPA should be alert to accounting policies and procedures that are unusual as compared with normal practices within the industry.

c. **Read the Financial Statements** Before submission, the CPA should read the financial statements to consider if they

- Appear to be appropriate in form; and
- Are free from obvious material errors.

This would encompass detection of math or clerical errors and misapplication of accounting principles, including inadequate disclosure.

d. **Problems With Information or Fraud / Illegal Acts** Although a CPA is not required to verify information supplied by the client, a CPA may become aware that information is unsatisfactory or that fraud or an illegal act may have occurred. The CPA should request that management consider the effect of these matters on the financial statements. The CPA should then consider the effect of management's conclusions on the CPA's compilation report. If the financial statements may be materially misstated and the client refuses to supply additional or revised information, the CPA should withdraw from the engagement.

6. **Documentation**

   a. **Purpose** The documentation is the CPA's primary support that the engagement was performed in accordance with SSARS as stated in the report.

   b. **Content** The CPA should prepare documentation in sufficient detail to provide a clear understanding of the work performed. It should include

      - The engagement letter;
      - Significant findings or issues and their resolution; and
      - Communications, oral or written, to management about fraud or illegal acts.

7. **Reporting**

   a. **When a Report is Not Required** When a CPA submits compiled financial statements to a client that are **not** expected to be used by a third party, a report is not required; however, each page of the financial statements should include a reference restricting their use, such as *Restricted for Management's Use Only*.

   b. **When a Report is Required** When a CPA is engaged to report on compiled financial statements or submits financial statements that are to be used by a third party, the statements should be accompanied by a written report. Procedures that may have been performed as part of the compilation engagement should **not** be described in the report.

   c. **Standard Compilation Report Structure** The standard report is comprised of three paragraphs:

      - Introductory paragraph
      - Management's responsibilities paragraph
      - Accountant's responsibilities paragraph

Exhibit 1 ▸ Standard Compilation Report

Accountant's Compilation Report

[*Appropriate Salutation*]

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

> Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.
>
> [*Signature of accounting firm or accountant, as appropriate*]
>
> [*Date*]

Editor note: The management's responsibilities paragraph is the same as for a review report (AR 90) covered in this chapter.

d. **Title** If applicable, the title may be Independent's Accountant's Compilation Report.

e. **Date** The date of completion of the compilation should be the date of the report.

f. **Financial Statements' Reference to Report** Each page of the financial statements should include a reference, such as *See Accountant's Compilation Report*.

g. **Financial Statements That Omit Substantially All Disclosures** A CPA may be requested to compile financial statements that omit substantially all disclosures required by an applicable financial reporting framework. This is permissible as long as the intent is not to mislead. An explanatory paragraph should be added **after** the accountant's responsibilities paragraph.

Exhibit 2 ▸ Substantially All Disclosures Omitted Explanatory Paragraph

> Management has elected to omit substantially all of the disclosures required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.

h. **Financial Statements That Include Only a Few Disclosures** When the entity wishes to include disclosures about only a few matters in the form of notes to the financial statements, such disclosures should be labeled *Selected Information—Substantially All Disclosures Required by* [identify the applicable financial reporting framework] *Are Not Included*.

i. **Reporting When Not Independent** A CPA is **not** required to be independent of an entity to issue a compilation report; however,

(1) **Report Modification** The report should be modified by adding a final paragraph that specifically discloses the lack of independence, such as: *We are not independent with respect to XYZ Company*.

(2) **Disclosure of Reasons Is Permitted** 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 a final paragraph disclosing the reason for the impairment of independence is *We are not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because a member of the engagement team had a direct financial interest in XYZ Company*.

j. Emphasis of a Matter Paragraph As long as the matter is disclosed in the financial statements (emphasis paragraphs should not be used in lieu of management disclosures), a CPA may add a separate explanatory paragraph to the report to emphasize a matter. Emphasis paragraphs are never required.

Editor note: This guidance is essentially the same for a review engagement (AR 90) covered in this chapter.

k. Material Departures From Applicable Financial Reporting Framework / Financial Statements Not Revised

(1) When Modification of the Report Is Adequate The departure should be disclosed in a separate paragraph of the report, including disclosure of the effects on the financial statements. If the effects have not been determined by management or are not known as the result of the CPA's procedures, the CPA is not required to determine them; however, the report should include a statement that such determination has not been made.

(2) When Modification of the Report Is Not Adequate If modification of the report is not adequate to indicate the deficiencies in the financial statements as a whole, the CPA should withdraw from the engagement and provide no further services with respect to those financial statements. The CPA may wish to consult with legal counsel.

Editor note: Except for the report modifications, this guidance is essentially the same for a review engagement (AR 90) covered in this chapter.

Exhibit 3 ▸ Compilation Report Disclosing a Departure From Applicable Financial Reporting Framework

Accountant's Compilation Report

Introductory Paragraph
Same as standard compilation report

Management's Responsibilities Paragraphs
Same as standard compilation report

Accountant's Responsibilities Paragraph
Same, except the following is added as the last sentence:
During our compilation, we did become aware of a departure from accounting principles generally accepted in the United States of America that is described in the following paragraph.

Explanatory Paragraph Added

As disclosed in Note X to the financial statements, accounting principles generally accepted in the United States of America require that land be stated at cost. Management has informed us that the company has stated its land at appraised value and that, if accounting principles generally accepted in the United States of America had been followed, the land account and stockholders' equity would have been decreased by $500,000.

l. **Restricted Use Reports**

(1) **General Use Reports** Reports on financial statements prepared in conformity with an applicable financial reporting framework ordinarily are not restricted regarding use. These are known as *general use* reports

(2) **Restricted Use Reports** The term restricted use applies to reports intended only for one or more specified third parties. The need for restriction may result from the purpose of the report and the potential for the report to be misunderstood when taken out of the context. A CPA should restrict the use of a report when the subject matter or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with an applicable financial reporting framework.

(3) **General & Restricted Subject Matter Combined in One Report** The combined report should be restricted.

(4) **Paragraph Added to Restrict Use of the Report** The paragraph should be added to the end of the report and should include:

- A statement that the report is intended solely for the use of the specified parties.
- An identification of the specified parties.
- A statement that the report is not intended to be and should not be used by anyone other than the specified parties.

Editor note: This guidance is essentially the same for a review engagement (AR 90) covered in this chapter.

m. **Going Concern Problems** If disclosure about the uncertainty is excluded or inadequate it should be handled in the CPA's report like any other material departure from an applicable financial reporting framework. If disclosed, the CPA may elect to include an emphasis paragraph.

Editor note: This guidance is essentially the same for a review engagement (AR 90) covered in this chapter.

n. **Subsequent Events** If the subsequent event is not adequately accounted for in the financial statements or disclosed in the notes, it should be handled in the CPA's report like any other material departure from an applicable financial reporting framework. If disclosed, the CPA may elect to include an emphasis paragraph.

Editor note: This guidance is essentially the same for a review engagement (AR 90) covered in this chapter.

o. **Subsequent Discovery of Facts Existing at the Date of the Report** The guidance is essentially the same as for an audit engagement as covered in Chapter 28.

Editor note: This guidance is essentially the same for a review engagement (AR 90) covered in this chapter.

p. Supplementary Information

(1) Degree of Responsibility When the financial statements are accompanied by information presented for supplementary analysis purposes, the CPA should clearly indicate the degree of responsibility, if any, the CPA is taking with respect to such information.

(2) Report Modification When the CPA has compiled both the financial statements and other data presented only for supplementary analysis purposes, the report should refer to the other data, or the CPA can issue a separate report on the other data. If a separate report is issued, the report should state that the other data accompanying the financial statements is presented only for the purposes of additional analysis, and that it has been compiled from information that is the representation of management, without audit or review, and that the CPA does not express an opinion or provide any assurance on such data.

8. Communications Regarding Fraud or Illegal Acts When information comes to the CPA's attention that fraud or an illegal act may have occurred, it should be brought to the attention of the appropriate level of management. The CPA should also consider consulting with legal counsel.

a. Inconsequential The CPA need not report matters that are clearly inconsequential and may reach agreement in advance with the entity on the nature of such items to be communicated.

b. Senior Management Implicated When such matters involve senior management, the CPA should report the matter to an individual or group at a higher level, such as the owner or those charged with governance. Communication can be oral or written; if oral, the CPA should document it.

c. Owner Implicated When matters involve an owner of the business, the CPA should consider withdrawing from the engagement.

d. Duty to Disclose to Outside Parties The guidance is essentially the same as for an audit client as covered in Chapter 22.

Editor note: This guidance is essentially the same for a review engagement (AR 90) covered in this chapter.

9. Change in Engagement Before the completion of the audit or review, a CPA may be requested to change the engagement to a compilation.

a. Considerations Before the CPA agrees to change the engagement to a compilation, the following should be considered:

- The client's reason for the request, particularly the implications of a restriction on the scope of the audit or review
- The additional effort required to complete the audit or review
- The estimated additional cost to complete the audit or review

If the additional cost or effort to complete the audit or review is minimal, the CPA should consider the propriety of accepting a change in the engagement.

b. Reasonable Bases for Change in Engagement

(1) Change in Circumstances A change in circumstances affecting the entity's requirement for an audit or review

(2) Misunderstanding A misunderstanding regarding the nature of an audit, review, or compilation

c. Scope Restriction of Audit or Review If the reason for the request is due to a restriction on the scope of the audit or review, whether imposed by the client or caused by circumstance, the decision to change the engagement can be more problematic. The CPA should evaluate the possibility that information affected by the scope restriction may be incorrect, incomplete, or otherwise unsatisfactory.

Ordinarily, the CPA is precluded from issuing a compilation report when

- During an audit, the CPA has been prohibited by the client from corresponding with the entity's legal counsel; or
- During an audit or review, a management representation letter is not provided.

d. When Change to a Compilation Occurs The compilation report should **not** include reference to

- The original engagement;
- Any audit or review procedures that may have been performed; or
- Any scope limitations that resulted in the changed engagement.

Editor note: This guidance is essentially the same for a review engagement (AR 90) covered in this chapter.

C. Review of Financial Statements (AR 90)

1. Applicability A CPA is required to comply with this guidance whenever the CPA has been engaged to review financial statements, except for reviews of interim financial information if the following are true:

- The entity's latest annual financial statements have been audited;
- The CPA expects to audit the entity's current year financial statements; and
- The same financial reporting framework used to prepare the annual financial statements is used for the interim financial information.

When all of these conditions are met, interim reviews should be performed in accordance with GAAS (AU 722, *Interim Financial Information*) instead of SSARS. In this circumstance, the review engagement is generally intended to provide a periodic update to the year-end reporting and is considered an extension of the annual audit. Thus, the standard setters decided the guidance should reside in the auditing literature.

2. Objective / Limitation A review is a service, the objective of which is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

3. **Independence** A CPA is precluded from performing a review engagement if the CPA's independence is impaired for any reason.

4. **Engagement Letter**

   a. **Establish & Document an Understanding With the Client** The CPA should establish an understanding with the client regarding the services to be performed and should document the understanding through a written communication with management, i.e., an engagement letter.

   b. **Contents** The engagement letter should include the objectives and limitations of the engagement as well as management's and the CPA's responsibilities. Thus, the understanding should address the following items:

      - *The objective of a review is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.
      - *Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
      - *Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
      - Management is responsible for preventing and detecting fraud.
      - Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
      - Management is responsible for making all financial records and related information available to the CPA.
      - Management will provide the CPA, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.
      - *The CPA is responsible for conducting the engagement in accordance with SSARS issued by the AICPA.
      - *A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management.
      - *A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole.
      - A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents (for example, cancelled checks or bank images); or other procedures

ordinarily performed in an audit. *Accordingly, the CPA will not express an opinion regarding the financial statements as a whole.

- The engagement cannot be relied upon to disclose errors, fraud, or illegal acts.

- The CPA will inform the appropriate level of management of any material errors and of any evidence or information that comes to the CPA's attention during the performance of review procedures that fraud or an illegal act may have occurred. The CPA need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.

*Editor note: These statements or words to the same effect are also included in the CPA's review report.

c. Additional Matters If Applicable The engagement letter should also address the following additional matters if applicable:

- Material departures from the applicable financial reporting framework may exist, and the effects of those departures, if any, on the financial statements may not be disclosed.

- Reference to supplementary information

d. Optional Matters The letter may also include other matters, for example, fees and billings.

5. Performance Requirements Review evidence obtained through the performance of analytical procedures and inquiries will ordinarily provide the CPA with a reasonable basis for expressing limited assurance; however, the CPA should perform additional procedures if necessary. The design and performance of review procedures should be based on the CPA's understanding of the industry and the client as well as awareness of the risk that the financial statements may be materially misstated. The CPA should focus the analytical procedures and inquiries in areas of increased risk of misstatement.

a. Understanding of the Industry The CPA should possess an understanding of the industry in which the client operates, including the accounting principles and practices generally used in the industry sufficient to assist the CPA with determining the specific nature, timing, and extent of review procedures to be performed. A CPA can accept an engagement for an entity in an industry in which the CPA has no previous experience as long as the CPA can acquire the knowledge by consulting AICPA guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, appropriate continuing professional education, or individuals knowledgeable about the industry.

b. Knowledge of the Client An understanding of the client's business and knowledge of the accounting principles and practices of the client's industry is needed so that the CPA can determine and apply appropriate inquiries and analytics.

(1) Business A CPA should obtain a general understanding of the client's organization; operating characteristics; and the nature of its assets, liabilities, revenues, and expenses. This knowledge is usually acquired through experience with the client or its industry and inquiry of its personnel.

(2) **Accounting Principles & Practices** The CPA should obtain an understanding of the accounting principles and practices used by the client in measuring, recognizing, recording, and disclosing all significant accounts and disclosures in the financial statements. The CPA can gain this understanding through inquiry, the review of client prepared documents, or experience with the client. The CPA should be alert to accounting policies and procedures that are unusual as compared with normal practices within the industry.

c. **Analytical Procedures** If analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the CPA should investigate these differences by inquiring of management and performing other procedures. Although the CPA is not required to corroborate management's responses with other evidence (as in an audit), the CPA may need to perform other procedures when, for example, management is unable to provide an explanation, or the explanation, together with review evidence obtained relevant to management's response, is not considered adequate. In other words, the CPA should consider the reasonableness and consistency of management's responses.

d. **Inquiries of Financial Management** The CPA should consider making the following inquiries of financial management:

- Whether the financial statements have been prepared in conformity with the applicable financial reporting framework
- The client's accounting principles and practices and the methods followed in applying them and procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements
- Unusual or complex situations that may have an effect on the financial statements
- Significant transactions occurring or recognized near the end of the reporting period
- The status of uncorrected misstatements identified during the previous engagement
- Questions that have arisen in the course of applying the review procedures
- Events subsequent to the date of the financial statements that could have a material effect on the financial statements
- Their knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements
- Significant journal entries and other adjustments
- Communications from regulatory agencies

e. Other Inquiries & Review Procedures The CPA should also consider making these inquiries or performing these procedures:

- Inquiries concerning actions taken at meetings of stockholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements

- Reading the financial statements to consider whether they appear to conform with the applicable financial reporting framework

- Obtaining reports from other accountants, if any, who have been engaged to audit or review the financial statements of significant components of the entity, its subsidiaries and other investees

Again, the CPA is not required to corroborate management's responses with other evidence; however, the CPA should consider the reasonableness and consistency of management's responses in light of the results of other review procedures and the CPA's knowledge of the client's business and the industry in which it operates.

f. Management Representations The CPA must obtain representations from management for all financial statements and periods covered by the review report.

(1) Content The CPA should request that management provide written representations related to the following matters; however the representation letter ordinarily should be tailored to include additional appropriate representations relating to matters specific to the entity's business or industry.

- Management's acknowledgment of its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework

- Management's belief that the financial statements are fairly presented in conformity with the applicable financial reporting framework

- Management's acknowledgement of its responsibility for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements

- Management's acknowledgement of its responsibility to prevent and detect fraud

- Knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others

- Management's full and truthful response to all inquiries

- Completeness of information

- Information concerning subsequent events

(2) Date The letter should be dated as of the date of the CPA's review report.

(3) Address The letter should be addressed to the CPA.

(4) **Signatures** The letter should be signed by members of management that are responsible for and knowledgeable about the matters covered. Current management must provide the representations for all periods covered by the financial statements and the review report even if they were not present for all periods. Normally, the chief executive officer and chief financial officer or others with equivalent positions in the entity should sign the representation letter.

(5) **Updating Management Representations** The guidance for obtaining an updated management representation letter is essentially the same as for an audit covered in Chapter 24.

6. Documentation

a. **Purpose** The documentation is the CPA's primary support for both the representation in the CPA's review report that the engagement was performed in accordance with SSARS and for the limited assurance expressed in the report.

b. **Content** The CPA should prepare documentation in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of review procedures performed); the review evidence obtained and its source; and the conclusions reached. Because of differing circumstances, it is not possible to specify the form, content, or extent of the documentation that a CPA should prepare for each engagement; however, it should include the following:

- The engagement letter
- Analytical procedures performed, including:
    - The expectations and the factors considered in their development
    - The results of the comparison of the expectations to the recorded amounts or ratios
    - Management's responses to the CPA's inquiries regarding fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount
- A description and the results of any additional procedures performed in response to significant unexpected differences arising from analytical procedures
- Significant matters covered by the CPA's inquiries and the responses
- Any significant findings or issues (for example, the results of review procedures that indicate the financial statements could be materially misstated) including actions taken and final conclusions
- Significant unusual matters that the CPA considered while performing the review procedures, including their disposition
- Communications (oral and written) to management about fraud or illegal acts
- Management's representation letter

c. **Oral Explanations** Oral explanations on their own do not represent sufficient support for the work performed or conclusions reached but may be used to clarify or explain information contained in the documentation.

7. **Incomplete Review** When the CPA is unable to perform the inquiry and analytical procedures necessary to obtain limited assurance or the client does not provide the CPA with a representation letter, the review will be incomplete and a review report should **not** be issued. In such a situation, the CPA should consider whether it is appropriate to issue a compilation report on the financial statements.

8. **Reporting** Financial statements reviewed by a CPA should be accompanied by a written report.

a. **Standard Review Report Structure** The standard report is comprised of four paragraphs:

- Introductory paragraph
- Management's responsibilities paragraph (same as for the standard compilation of financial statements report)
- Accountant's responsibilities paragraph
- Results of engagement paragraph

Exhibit 4 ▸ Standard Review Report

Independent Accountant's Review Report

[*Appropriate Salutation*]

We have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

[*Signature of accounting firm or accountant, as appropriate*]

[*Date*]

b. **Date** The report should not be dated earlier than the date on which the CPA has accumulated review evidence sufficient to provide a reasonable basis for concluding that the CPA has obtained limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

c. **Financial Statements' Reference to the Report** Each page of the financial statements should include a reference, such as *See Independent Accountant's Review Report*.

d. **Limited Reporting Engagement** A CPA may be asked to issue a review report on one financial statement, such as a balance sheet, and not on other related financial statements, such as the statements of income, retained earnings, and cash flows. The CPA may do so if the scope of the CPA's inquiries and analytical procedures has not been restricted.

e. **Emphasis of a Matter Paragraph** The guidance is the essentially the same as for a compilation engagement (AR 80) covered in this chapter.

f. **Material Departures From Applicable Financial Reporting Framework / Financial Statements Not Revised** Except for the report modifications shown in the next exhibit, the guidance is essentially the same as for a compilation engagement (AR 80) covered in this chapter.

Exhibit 5 ▸ Review Report Disclosing a Departure From Applicable Financial Reporting Framework

Independent Accountant's Review Report

Introductory & Management's Responsibilities Paragraphs
Same as standard review report

Accountant's Responsibilities Paragraph
Modification shown in boldface

Based on our review, **with the exception of the matter described in the following paragraph**, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

Explanatory Paragraph Added

As disclosed in Note X to the financial statements, accounting principles generally accepted in the United States of America require that land be stated at cost. Management has informed us that the company has stated its land at appraised value and that, if accounting principles generally accepted in the United States of America had been followed, the land account and stockholders' equity would have been decreased by $500,000.

g. **Restricted Use Reports** The guidance is essentially the same as for a compilation engagement (AR 80) covered in this chapter.

h. **Going Concern Problems** The guidance is essentially the same as for a compilation engagement (AR 80) covered in this chapter.

i. **Subsequent Events** The guidance is essentially the same as for a compilation engagement (AR 80) covered in this chapter.

j. **Subsequent Discovery of Facts Existing at the Date of the Report** As was the case for a compilation engagement, the guidance is essentially the same as for an audit engagement covered in Chapter 28.

k. **Supplementary Information** When the financial statements are accompanied by information presented for supplementary analysis purposes, the CPA should clearly indicate the degree of responsibility, if any, the CPA is taking with respect to such information.

When the CPA has reviewed the financial statements, an explanation should be included in the review report or in a separate report on the other data. The report should state that the review has been made for the purpose of expressing a conclusion that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework and the other data accompanying the financial statements is presented only for purposes of additional analysis and that it either

- Has been subjected to the inquiry and analytical procedures applied in the review of the financial statements, and the CPA did not become aware of any material modifications that should be made to such data, *or*

- Has **not** been subjected to the inquiry and analytical procedures applied in the review of the financial statements, but was compiled from information that is the representation of management, without audit or review, and the CPA does not express an opinion or provide any assurance on such data.

9. **Communications Regarding Fraud or Illegal Acts** The guidance is essentially the same as for a compilation engagement (AR 80) covered in this chapter.

10. **Change in Engagement from Audit to a Review** The guidance is essentially the same as for a change in engagement from an audit or review to a compilation (AR 80) covered in this chapter.

D. **Compilation Reports on Financial Statements in Certain Prescribed Forms (AR 300)** A prescribed form is any standard preprinted form adopted by the body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. A form adopted by the entity whose financial statements are to be compiled is **not** considered to be a prescribed form.

1. **Applicability** SSARS guidance on compilations (AR 80) and reporting on comparative financial statements (AR 200) is applicable when the unaudited financial statements are included in a prescribed form.

This standard (AR 300) provides guidance when the prescribed form or related instructions call for a departure from the applicable financial reporting framework in a compilation engagement. The nature of the departure may be the specification of a nonconforming measurement principle or the failure to request the required presentation or disclosures.

This standard also provides additional guidance applicable to reports on financial statements included in a prescribed form.

2. **Departures From the Reporting Framework Required by the Prescribed Form** There is a presumption that the information required by a prescribed form is sufficient

to meet the needs of the body that adopted the form; thus, there is no need to advise that body about departures from the applicable financial reporting framework required by the prescribed form or related instructions. However, note that the report should be a restricted use report.

Exhibit 6 ▸ Compilation Report for a Prescribed Form That Calls for a Departure From the Applicable Financial Reporting Framework

Accountant's Compilation Report

We have compiled the [*identification of financial statements, including period covered and the name of entity*] included in the accompanying prescribed form. We have not audited or reviewed the financial statements included in the accompanying prescribed form and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements included in the form prescribed by [*name of body*] in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The financial statements included in the accompanying prescribed form are presented in accordance with the requirements of [*name of body*], and are not intended to be a presentation in accordance with accounting principles generally accepted in the United States of America.

This report is intended solely for the information and use of [*the specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

3. **Other Departures From the Reporting Framework or From the Requirements of the Prescribed Form** If a departure from the applicable financial reporting framework other than departures required by the prescribed form or a departure from the prescribed form's requirements exist, the CPA should follow SSARS guidance on compilations (AR 80) regarding departures from the applicable financial reporting framework.

4. **Preprinted Form Not Conforming With SSARS** A CPA should not sign a preprinted report form that does not conform with SSARS compilation guidance in AR 80 or this standard (AR 300), whichever is applicable. In such circumstances, the CPA should append an appropriate report to the prescribed form.

E. Personal Financial Statements (AR 600)

1. **Purpose** This standard allows a CPA to submit a written personal financial plan containing unaudited personal financial statements to a client without complying with SSARS guidance on compilations (AR 80) when certain conditions exist.

2. **Conditions for Exemption From SSARS** The CPA may elect to take the exemption if *all* of the following conditions are met:

    - The CPA establishes an understanding with the client and documents the understanding through a written communication with the client that the financial statements
        - Will be used solely to assist the client and the client's advisers to develop the client's personal financial goals and objectives; and
        - Will not be used to obtain credit or for any purposes other than developing these goals and objectives.
        - Nothing comes to the CPA's attention during the engagement that would cause the CPA to believe that the financial statements will be used to obtain credit or for any purposes other than developing the client's financial goals and objectives.

3. **Report Required** The issuance of a written report is required if this exemption is exercised. Note that the CPA states that the financial statement has not been audited, reviewed, *or compiled.*

Exhibit 7 ▸ Report When the CPA Submits a Written Financial Plan Containing Unaudited Personal Financial Statements That Are Exempt From AR 80

> The accompanying Statement of Financial Condition of X, as of December 31, 20XX, was prepared solely to help you develop your personal financial plan. Accordingly, it may be incomplete or contain other departures from accounting principles generally accepted in the United States of America and should not be used to obtain credit or for any purposes other than developing your financial plan. We have not audited, reviewed, or compiled the statement.

F. Communications Between Predecessor & Successor Accountants (AR 400)

1. **Purpose** This standard provides guidance to a successor CPA who decides to communicate with a predecessor CPA about the acceptance or performance of a compilation or review engagement. The successor should bear in mind that the predecessor and the client may have disagreed about accounting principles, procedures applied by the predecessor, or similarly significant matters.

2. **Definitions**

    a. **Successor** The successor is either considering making a proposal to compile or review financial statements or has accepted the engagement.

    b **Predecessor** The predecessor may have reported on the most recent financial statements or been engaged to perform, but did not complete, a review or compilation and has either resigned or been terminated.

3. **Client Consent** As with an audit, a successor should obtain specific consent from a prospective client to make any inquiries of a predecessor and request that the client authorize the predecessor to respond fully. If the prospective client refuses to permit the predecessor to respond or limits the response, the successor should inquire about the reasons and consider the implications regarding the pursuance of the engagement.

    Upon acceptance, the successor may wish to review the predecessor's engagement documentation. The successor should also request the client to ask the predecessor to allow this access.

4. **Communication with Predecessor Regarding Engagement Acceptance**

   a. **Circumstances When Communication Is Recommended** Unlike an audit, a successor is **not** required to communicate with a predecessor regarding the acceptance of a compilation or review engagement, but may deem it prudent to do so when, for example,

      - Information obtained about the prospective client is limited or appears to require special attention;
      - The change in CPAs takes place substantially after the end of the accounting period; or
      - There have been frequent changes in CPAs.

   b. **Inquiries** The guidance regarding the inquiries is essentially the same as for an audit as covered in Chapter 21 with these differences:

      - SSARS include an inquiry about the cooperation of management in providing additional or revised information, if necessary.
      - SSARS do **not** include an inquiry about significant deficiencies and material weaknesses in internal control (because neither a review nor a compilation requires obtaining an understanding of the client's internal control).

   c. **Responses** The guidance regarding the responses is essentially the same as for an audit as covered in Chapter 21.

5. **Other Inquiries**

   a. **Engagement Documentation** The guidance regarding inquiries involving engagement documentation is essentially the same as for an audit as covered in Chapter 21. SSARS provide a shorter list of documentation that would most likely be of interest: documentation relating to contingencies and other matters of continuing accounting significance.

   b. **Reference** The successor should **not** refer to the report or work of the predecessor in the report, except as specifically permitted by AR 200 with respect to the financial statements of a prior period.

6. **Prior Financial Statements Require Revision**

   a. **Course of Action** If revisions to the financial statements reported on by the predecessor may be required, the successor should ask the client to contact the predecessor. The successor should follow the guidance on compilations (AR 80) and reviews (AR 90) regarding subsequent discovery of facts existing at the date of the report which is essentially the same as for an audit covered in Chapter 28.

   b. **If Client Does Not Cooperate** The guidance is essentially the same as for an audit as covered in Chapter 21.

G. Compilations of Presentations Other Than Financial Statements (AR 110 & 120)

1. Compilation of Specified Elements, Accounts, or Items of a Financial Statement (AR 110)

a. Applicability A CPA is required to comply with this guidance whenever the CPA is engaged to report on one or more compiled specified elements, accounts, or items of a financial statement (items) or submits same to a client or to third parties. However, if the item is included as supplementary information, the CPA should refer to that topic (supplementary information) in AR 80.

b. Definition A compilation of an item is limited to assisting management in presenting financial information without undertaking to obtain or provide any assurance that there are no material modifications that should be made to that information. This may be undertaken as a separate engagement or in conjunction with a compilation, review, or audit of financial statements. Examples of items that a CPA may compile include schedules of rentals, royalties, profit participation, or provision for income taxes.

c. Engagement Letter This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

d. Performance Requirements This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

e. Documentation This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

f. Reporting

(1) Whether to Issue a Report A report is **not** required for this engagement unless the CPA has been engaged to report on the item. However, if it is likely that the CPA's name will be associated with the presentation and because of that a user may inappropriately infer an unintended level of assurance, the CPA should consider issuing a report. Procedures that the may have been performed as part of the compilation engagement should not be described in the report.

(2) Report Structure

Exhibit 8 ▸ Standard Compilation Report on a Schedule of Accounts Receivable

Accountant's Compilation Report *All 3 Paragraphs* *Same as for a compilation of financial statements* Except Replace the references to *financial statements* with *schedule of the item*

(3) Title This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

(4) Date This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

(5) **Financial Statements Reference to Report** This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

(6) **Engagement in Conjunction with a Compilation of Financial Statements** If this compilation was performed in conjunction with a compilation of financial statements, the introductory paragraph should so state and indicate the date of the compilation report on the financial statements. Any departure from the standard report on those statements should also be disclosed if considered relevant to the presentation of the item.

(7) **Reporting When Not Independent** This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

g. **Communications Regarding Fraud or Illegal Acts** This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

2. Compilation of *Pro Forma* Financial Information (AR 120)

a. **Applicability** A CPA is required to comply with this guidance whenever the CPA is engaged to report on *pro forma* financial information or submits same to a client or to third parties. However, if the *pro forma* financial information is included as supplementary information, the CPA should refer to that topic (supplementary information) in AR 80.

b. **Definition** A compilation of *pro forma* financial information is limited to assisting management in presenting financial information without undertaking to obtain or provide any assurance that there are no material modifications that should be made to that information. This may be undertaken as a separate engagement or in conjunction with a compilation, review, or audit of financial statements.

c. **Objective** The objective of *pro forma* financial information is to show what the significant effects on historical financial information might have been had a consummated or proposed transaction (or event) occurred at an earlier date. *Pro forma* financial information is commonly used to show the effects of transactions such as the following:

- Business combination
- Change in capitalization
- Disposition of a significant portion of the business
- Change in the form of business organization or status as an autonomous entity
- Proposed sale of securities and the application of the proceeds

This objective is achieved primarily by applying *pro forma* adjustments to historical financial information. *Pro forma* adjustments should be based on management's assumptions and give effect to all significant effects directly attributable to the transaction (or event).

d. Presentation

(1) Labeling *Pro forma* financial information should be labeled as such to distinguish it from historical financial information.

(2) Description This presentation should describe:

- The transaction (or event) that is reflected in the *pro forma* financial information
- The source of the historical financial information on which it is based
- The significant assumptions used in developing the *pro forma* adjustments
- Any significant uncertainties about those assumptions

(3) Cautions The presentation should also indicate that the *pro forma* financial information should be read in conjunction with the related historical financial information and that the *pro forma* financial information is not necessarily indicative of the results (such as financial position and results of operations, as applicable) that would have been attained had the transaction (or event) actually taken place earlier.

e. Conditions for Compiling *Pro Forma* Financial Information

(1) Historical Financial Statements Included A CPA may only compile *pro forma* financial information if the document that contains it includes (or incorporates by reference) the historical financial statements of the entity on which the *pro forma* financial information is based. Historical interim financial information may be presented in condensed form. In the case of a business combination, the document should include (or incorporate by reference) the appropriate historical financial information for the significant constituent parts of the combined entity.

(2) Audit, Review, or Compilation of Historical Financial Statements Required The historical financial statements of the entity (or, in the case of a business combination, of each significant constituent part of the combined entity) on which the *pro forma* financial information is based must have been compiled, reviewed, or audited.

(3) Report on Historical Financial Statements Included The CPA's compilation, review, or audit report on the historical financial statements should be included (or incorporated by reference) in the document containing the *pro forma* financial information.

f. Engagement Letter This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

g. Performance Requirements This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter. The requirement to read the *pro forma* financial information to consider if it appears to be appropriate in form and free of obvious material errors includes the summary of significant assumptions.

h. Documentation This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

i. Reporting

(1) Whether to Issue a Report This guidance is the same as for a compilation of specified elements, accounts, or items of a financial statement (AR 110) covered in this chapter.

(2) Report Structure The passages that differ from the standard report on a compilation of financial statements are shown in boldface.

Exhibit 9 ▸ Compilation Report on *Pro Forma* Financial Information (Reflecting a Business Combination)

Accountant's Compilation Report

We have compiled the accompanying ***pro forma* financial information** of XYZ Company as of December 31, 20XX, **reflecting the business combination of the Company and ABC Company**. **The historical condensed financial statements are derived from the historical unaudited financial statements of XYZ Company, which were compiled by us, and of ABC Company, which were compiled by other accountants.** We have not audited or reviewed the accompanying ***pro forma* financial information** and, accordingly, do not express an opinion or provide any assurance about whether the ***pro forma* financial information** is in accordance with accounting principles generally accepted in the United States of America.

Management's & Accountant's Responsibilities Paragraphs
Same as for a compilation of financial statements
Except replace
References to *financial statements* with *pro forma financial information*

Explanatory Paragraph Added
(Objective & limitations of pro forma financial information)

The objective of this *pro forma* financial information is to show what the significant effects on the historical financial information might have been had the transaction (or event) occurred at an earlier date. However, the *pro forma* financial information is not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the transaction (or event) actually occurred earlier.

(3) Title This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

(4) Date This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

(5) Financial Statements' Reference to Report This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

(6) Engagement in Conjunction with a Compilation of Financial Statements This guidance is the same as for a compilation of specified elements, accounts, or items of a financial statement (AR 110) covered in this chapter.

(7) **Modifications in the Report on Historical Financial Statements** The report on *pro forma* financial information should also refer (in the introductory paragraph) to any modifications in the CPA's report on the historical financial statements.

(8) ***Pro Forma* Financial Information That Omits Substantially All Disclosures** This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter. The explanatory paragraph required when management has elected to omit substantially all disclosures, but the *pro forma* financial information is otherwise in conformity with the applicable financial reporting framework should be added **after** the paragraph on the objectives and limitations of the *pro forma* financial information.

(9) **Reporting When Not Independent** This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

j. **Communications Regarding Fraud or Illegal Acts** This guidance is the essentially the same as for a compilation of financial statements (AR 80) covered in this chapter.

II. Compilations & Reviews for Nonissuers: Reporting on Comparative Financial Statements (AR 200)

A. Overview

Comparative financial statements are financial statements of two or more periods which are presented in a columnar format. AR 200 applies when reporting on comparative financial statements of a nonissuer when the financial statements of one or more periods presented have been compiled and reported on or reviewed per AR 80 or 90, respectively. The CPA should issue an appropriate report that covers each of the periods presented in the comparative financial statements.

1. **Report Structure** The same common report elements / paragraphs required for compilation and review reports on financial statements of a single period are applicable to comparative financial statements.

2. **Continuing Accountant** A CPA engaged to audit, review, or compile the current period's financial statements who has audited, reviewed, or compiled those of one or more consecutive periods immediately prior to the current period.

3. **Updated Report** A report issued by a continuing accountant. It takes into consideration information the continuing accountant becomes aware of during the current engagement. In it, depending on the circumstances, the continuing accountant will either re-express the previous conclusion on the prior period statements or express a different conclusion on the prior period statements as of the date of the current report.

4. **Reissued Report** A report issued after the date of the original report, but bearing the same date as the original report. If it must be revised because of the effects of specific events, it should be dual-dated, using the original date and a separate date that applies to the effects of such events.

5. **Client-Prepared Financial Statements Included on Separate Pages** It is permissible for the client to include client-prepared financial statements of some periods that have **not** been audited, reviewed, or compiled by the CPA on separate pages of a document containing financial statements of other periods on which the CPA has reported, if they are accompanied by an indication by the client that the CPA has not

audited, reviewed, or compiled those statements and does not assume any responsibility for them.

If financial statements of other periods that have not been audited, reviewed, or compiled are presented in columnar form in a document with financial statements on which a CPA has reported and the CPA's name has been used or the CPA's report has been included in the document, the CPA should advise the client that this is inappropriate. The CPA should consider what other actions might be appropriate, including consultation with an attorney.

6. **Modified & Unmodified Reports** A CPA may modify a report with respect to one or more financial statements for one or more periods while issuing an unmodified report on the other financial statements presented.

7. **Omission of Disclosures** Statements that omit substantially all disclosures are not comparable to financial statements that include such disclosures. Therefore, the CPA should not issue a report on comparative financial statements when statements for some, but not all, of the periods presented omit substantially all required disclosures.

8. **Financial Statements' Reference to Report** Each page of the comparative financial statements compiled or reviewed by the CPA should include a reference such as *See Accountant's Compilation Report* or *See Independent Accountant's Review Report*.

B. Continuing Accountant's Standard Report

1. **Same or Higher Level of Service in Current Period** A continuing accountant who performs the same or a higher level of service with respect to the financial statements of the current period should update the report on the prior period financial statements presented.

Exhibit 10 ▸ Compilation Report Both Periods

Accountant's Compilation Report

Introductory Paragraph
Same as standard report except for language change to cover more than 1 period

Management's Responsibilities Paragraph
Same as standard report

Accountant's Responsibilities Paragraph
Same as standard report except use of plural in:
"Our responsibility is to conduct the compilation<u>s</u> in accordance…"

Exhibit 11 ▸ Review Report Both Periods

> Independent Accountant's Review Report
>
> *Introductory Paragraph*
> *Same as standard report except for language change to cover more than 1 period*
>
> *Management's Responsibilities Paragraph*
> *Same as standard report*
>
> *Accountant's Responsibilities Paragraph*
> *Same as standard report except use of plural in:*
> "Our responsibility is to conduct the review<u>s</u> in accordance…"
>
> *Results of Engagement Paragraph*
> *Same as standard report except use of plural in:*
> "Based on our review<u>s</u>, we are not aware…

Exhibit 12 ▸ Current Period Reviewed / Prior Period Compiled

> Independent Accountant's Review Report
>
> *First 3 Paragraphs*
> *Same as standard report*
>
> *Results of Engagement Paragraph*
> *Same as standard report except financial statements reviewed are designated Year 2*
>
> *Updating Paragraph Added*
>
> The accompanying 20X1 financial statements of XYZ Company were compiled by us. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. Accordingly, we do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

2. **Lower Level of Service in Current Period** A continuing accountant who performs a lower level of service with respect to the financial statements of the current period should either (a) include as a separate paragraph of the report a description of the responsibility assumed for the financial statements of the prior period or (b) reissue the report on the financial statements of the prior period.

   a. **Compilation Report** The CPA should issue a compilation report on the current period financial statements that includes a description of the responsibility assumed for the financial statements of the prior period. The description should include the original date of the CPA's report and should also state that the CPA has not performed any procedures in connection with that review engagement after that date.

Exhibit 13 ▸ Current Period Compiled / Prior Period Reviewed

Accountant's Compilation Report

Introductory Paragraph
Same as standard report except disclaimer designates statements of Year 2

Management's & Accountant's Responsibilities Paragraphs
Same as standard report

The accompanying 20X1 financial statements were previously reviewed by us and we stated that we were not aware of any material modifications that should be made to those financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America in our report dated March 31, 20X2, but we have not performed any procedures in connection with that review engagement since that date.

b. **Combined Report** The CPA should combine the compilation report on the financial statements of the current period with the reissued review report on the financial statements of the prior period or present them separately. The combined report should state that the CPA has not performed any procedures in connection with that review engagement after the date of the review report.

C. **Continuing Accountant's Changed Reference to a Departure From the Applicable Financial Reporting Framework**

When the CPA's report on the prior period financial statements contains a changed reference to a departure from the applicable financial reporting framework, the report should include a separate explanatory paragraph indicating:

- The date of the CPA's previous report
- The circumstances or events that caused the reference to be changed
- That the prior period financial statements have been changed, when applicable

Exhibit 14 ▸ Explanatory Paragraph for Changed Reference to a GAAP Departure for a Compilation Report on Comparative Financial Statements

In our report dated March 1, 20X2 with respect to the 20X1 financial statements, we referred to a departure from accounting principles generally accepted in the United States of America because the company carried its land at appraised values. As described in Note X, the Company has changed its method of accounting for land and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America.

Exhibit 15 ▸ Explanatory Paragraph for Changed Reference to a GAAP Departure for a Review Report on Comparative Financial Statements

Same as the compilation report paragraph above with this additional sentence:

Accordingly, our present statement on the 20X1 financial statements, as presented herein, that we are not aware of any material modifications that should be made to the accompanying financial statements is different from that expressed in our previous report.

D. Predecessor's Compilation or Review Report
At the client's request, a predecessor CPA may reissue the compilation or review report on the prior period financial statements. However, a predecessor is not required to do so.

1. **Predecessor's Report Not Presented (Reissued)** When a predecessor has compiled or reviewed the financial statements of a prior period (that are presented for comparative purposes) but does not reissue the compilation or review report, the successor should either

   a. **Options**

   - Perform a compilation, review, or audit of the prior period financial statements and issue an appropriate report, or
   - Include an additional paragraph in the current report that makes reference to the predecessor's report on the prior period financial statements.

   b. **Making Reference to Predecessor's Report** The reference should *either be added to the end of the introductory paragraph or placed in a separate paragraph and should include:

   *Editor note: The guidance in AR 200.17 indicates an additional paragraph; however the illustrations in Exhibits A and B of AR 200 show the reference added to the end of the introductory paragraph.

   - A statement that other accountants compiled or reviewed the prior period financial statements (generally, the predecessor should not be named);
   - The date of the predecessor's report
   - The disclaimer (for a compilation) or limited assurance (for a review) statement that appeared in the report
   - A description of any modifications that were made to the standard report and of any paragraphs that were included to emphasize any matter in the financial statements

Exhibit 16 ▸ Reference In Compilation Report to the Predecessor's Report When It Is Not Presented (Reissued)

> The financial statements of XYZ Company as of December 31, 20X1, were compiled by other accountants whose report dated February 1, 20X2 stated that they have not audited or reviewed the 20X1 financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Exhibit 17 ▸ Reference In Review Report to the Predecessor's Report When It Is Not Presented (Reissued)

> The financial statements of XYZ Company as of December 31, 20X1, were reviewed by other accountants whose report dated February 1, 20X2, stated that based on their procedures, they are not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

2. **Predecessor's Report Reissued** If a predecessor is unable to complete the procedures described below the predecessor should not reissue the report and may wish to consult with an attorney regarding the appropriate course of action.

   a. **Considerations Prior to Reissue** Before reissuing a compilation or review report on the financial statements of a prior period, a predecessor should consider whether the report is still appropriate. The predecessor should consider:

      - The current form and manner of presentation of the prior period financial statements
      - Subsequent events not previously known
      - Changes in the financial statements that require the addition or deletion of modifications to the standard report

   b. **General Procedures Prior to Reissue** A predecessor should perform the following procedures before reissuing a compilation or review report on the financial statements of a prior period:

      - Read the current period financial statements and the report of the successor.
      - Compare the prior period financial statements with those previously issued and with those of the current period.
      - 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.

   c. **Directed Procedures Prior to Reissue** If the predecessor becomes aware of information that may affect the financial statements of the prior period or the report on them, the predecessor should make inquiries or perform analytics similar to the ones the predecessor would have performed at the date of the report on the prior period statements had the predecessor been aware of the information, and perform any other necessary procedures. Examples include discussion with the successor and review of the successor's engagement documentation on the matter.

   d. **Date of Reissued Report** The date of the previous report should be used when reissuing a report. This avoids any implication that the predecessor performed any procedures (other than those described above) after that date.

   e. **Dual Dating Reissued Report**. Dual dating is appropriate if the predecessor revised the report or if the financial statements are restated. The predecessor should also obtain a written statement from the former client setting forth the information currently acquired and its effect on the prior period financial statements and, if applicable, expressing an understanding of its effect on the predecessor's reissued report.

3. **Restated Prior Period Financial Statements** When prior period financial statements have been restated

- The predecessor may reissue the report (normally, this is what should happen as covered above); or

- The predecessor may **not** reissue the report and the successor may be engaged to report on the prior year financial statements; or

- The predecessor may **not** reissue the report and the successor may **not** be engaged to report on the prior year financial statements.

a. **Predecessor's Report Not Presented (Reissued) / Successor Engaged to Report on Prior Year** The successor should indicate in the introductory paragraph of the compilation or review report that a predecessor reported on the financial statements of the prior period before restatement. The successor may also indicate in the report that the successor compiled or reviewed the adjustments that were applied to restate prior year financial statements.

Exhibit 18 ▸ Reference to the Predecessor's Report When It Is Not Presented (Reissued) and the Successor Is Engaged to Compile the Restatement Adjustment(s)

Added to the end of the introductory paragraph:

The financial statements prior to adjustment of XYZ Company as of and for the year ended December 31, 20X1, were compiled by other accountants whose report dated February 1, 20X2, stated that they have not audited or reviewed the 20X1 financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Explanatory paragraph added to end of report

We also compiled the adjustments described in Note X that were applied to restate the 20X1 financial statements. We have not audited or reviewed the adjustments described in Note X that were applied to restate the 20X1 financial statements and, accordingly, do not express an opinion or provide any assurance about whether the adjustments described in Note X that were applied to restate the 20X1 financial statements are in accordance with accounting principles generally accepted in the United States of America.

Exhibit 19 ▶ Reference to the Predecessor's Report When It Is Not Presented (Reissued) and the Successor Is Engaged to Review the Restatement Adjustment(s)

Added to the end of the introductory paragraph:

The financial statements of XYZ Company as of December 31, 20X1 prior to adjustment were reviewed by other accountants whose report dated February 1, 20X2, stated that based on their procedures, they are not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

Explanatory paragraph added to end of report

We also reviewed the adjustments described in Note X that were applied to restate the 20X1 financial statements. Based on our review, we are not aware of any material modifications that should be made to the adjustments described in Note X that were applied to restate the 20X1 financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

b. **Predecessor's Report Not Presented (Reissued) / Successor Not Engaged to Report on Prior Year** The successor should indicate in the introductory paragraph of the compilation or review report that a predecessor reported on the financial statements of the prior period before restatement.

E. Reporting When Prior Period Is Audited

1. **Options** When the current period financial statements of a nonissuer have been compiled or reviewed and those of the prior period have been audited, the CPA should issue an appropriate compilation or review report on the current period financial statements and either

   - The report on the prior period should be reissued; or
   - The report on the current period should include as a separate paragraph a description of the responsibility assumed for the financial statements of the prior period.

2. **Separate Paragraph on Responsibility Assumed** The separate paragraph should indicate:

   - That the financial statements of the prior period were audited previously
   - The date of the previous report
   - The type of opinion expressed previously
   - If the opinion was other than unqualified, the substantive reasons
   - That no auditing procedures were performed after the date of the previous report

Exhibit 20 ▶ Final Paragraph for Compilation or Review Report When Prior Period Was Audited

The 20X1 financial statements were audited by (us) (other accountants) and (we) (they) expressed an unqualified opinion on them in (our) (their) report dated March 1, 20X2, but (we) (they) have not performed any auditing procedures since that date.

F. Reporting on Financial Statements That Previously Did Not Omit Disclosures

Even though a CPA may have compiled, reviewed, or audited financial statements that did **not** omit substantially all required disclosures, the CPA may later be asked to compile financial statements for the same period that **do** omit substantially all the disclosures required by the applicable financial reporting framework so that the statements can be presented in comparative financial statements. In this case, the CPA may report on these statements as long as an additional paragraph is included in the report that indicates the nature of the previous service and the date of the previous report.

Exhibit 21 ▸ Prior Period Statements Omitting Substantially All Disclosures Compiled From Previously Reviewed Statements

> We have compiled the accompanying balance sheets of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.
>
> Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
>
> Our responsibility is to conduct the compilations in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.
>
> Management has elected to omit substantially all of the disclosures required by accounting principles generally accepted in the United States of America. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, the financial statements are not designed for those who are not informed about such matters.
>
> The 20X1 financial statements were compiled by us from financial statements that did not omit substantially all of the disclosures required by accounting principles generally accepted in the United States of America and that we previously reviewed as indicated in our report dated March 1, 20X2.

SSAE 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence is Impaired*; issued 12/2010

This statement will be eligible to be tested beginning with the July-August 2011 exam window. In December 2010 the Accounting Standards Board of the AICPA issued Statement on Standards for Attestation Engagements (SSAE) 17. SSAE 17 is effective for compilations of prospective financial statements for periods ending on or after December 15, 2010. Early application is permitted.

This standard amends paragraph 23 of AT 301, *Financial Forecasts and Projections,* to permit, but not require, the accountant to disclose the reasons for a lack of independence in a report on compiled prospective financial information. (The former guidance is covered in the text that displays within our online courses and software in Chapter 31 in the 4th section: IV.B.8.e. and in the same section of the 40th edition of our textbook on page 31-39.)

Reporting When Not Independent A CPA is **not** required to be independent of an entity to issue a compilation report on prospective financial information; however,

- The report should be modified by adding a separate paragraph that specifically discloses the lack of independence, such as: *We are not independent with respect to XYZ Company*.
- The CPA may disclose the reason(s) the CPA's independence is impaired in the same 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: *We are not independent with respect to XYZ Company as of and for the year ended December 31, 20XX, because a member of the engagement team had a direct financial interest in XYZ Company*.

SAS 121, *Revised Applicability of Statement on Auditing Standards No. 100,* Interim Financial Information; issued 2/2011

This statement is eligible to be tested beginning with the October-November 2011 exam window. **Both the previous and the new guidance will be testable**. **Beginning with the January-February 2012 exam window, only the new guidance will be testable.**

In February 2011 the Auditing Standards Board of the AICPA issued Statement on Auditing Standards (SAS) 121. SAS 121 is effective for interim reviews of interim financial information for periods beginning after December 15, 2011. Early application is permitted.

SAS 121 amends paragraph 5 of AU 722, *Interim Financial Information*. This paragraph includes the conditions that require certain interim reviews for nonissuers to be performed in accordance with generally accepted auditing standards (AU 722, *Interim Financial Information*) rather than the SSARS. The new guidance allows for an appropriate transition between a predecessor auditor and the auditor of the current year financial statements in that AU 722 would be applicable when an accountant audited the entity's latest annual financial statements and the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the interim period to be reviewed. (The former guidance is covered in the text that displays within our online courses and software in Chapter 30 in the 5th section: V.A.3.b. and in the same section of the 40th edition of our textbook on page 30-19.)

The changes to paragraph 5 of AU 722 are shown below. New language is shown in boldface italics; deleted language is shown by strikethrough.

b. The accountant ***either***

   i. has been engaged to audit the entity's current year financial statements, or

   ii. ~~the accountant~~ audited the entity's latest annual financial statements and***, when it is expected that the current year financial statements will be audited,*** ~~expects to be engaged~~ ***the appointment of another accountant*** to audit the current year financial statements ***is not effective prior to the beginning of the period covered by the review***;

- **If you are testing in the July-August 2011 exam window**, disregard the language in boldface italics. Know the remainder, including the language shown by strikethrough.
- **If you are testing in the October-November 2011 exam window**, both the previous and the new guidance is testable. The previous guidance is shown by strikethrough.
- **Beginning with the January-February 2012 exam window,** only the new guidance is testable; simply disregard the language shown by strikethrough.

SSARS 20, *Revised Applicability of Statements on Standards for Accounting and Review Services*; issued 2/2011

This statement is eligible to be tested beginning with the October-November 2011 exam window. Both the previous and the new guidance will be testable. Beginning with the January-February 2012 exam window, only the new guidance will be testable.

In February 2011 the Accounting and Review Services Committee of the AICPA issued SSARS 20. SSARS 20 is effective for reviews of financial statements of nonissuers for periods beginning after December 15, 2011. Early application is permitted.

SSARS 20 amends paragraph 1 of AR 90, *Review of Financial Statements*. This paragraph includes the conditions that require certain interim reviews for nonissuers to be performed in accordance with generally accepted auditing standards (AU 722, *Interim Financial Information*) rather than the SSARS. The new guidance allows for an appropriate transition between a predecessor auditor and the auditor of the current year financial statements in that AU 722 would be applicable when an accountant audited the entity's latest annual financial statements and the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the interim period to be reviewed. (The former guidance is covered in the text that displays within our online courses and software in Chapter 31 in the 1st section: I.A. and in the same section of the 40th edition of our textbook on page 31-1.)

The changes to paragraph 1 of AR 90 are shown below. New language is shown in boldface italics; deleted language is shown by strikethrough.

b. The accountant **either**
   - i. has been engaged to audit the entity's current year financial statements, or
   - ii. ~~the accountant~~ audited the entity's latest annual financial statements and, **when it is expected that the current year financial statements will be audited**, ~~expects to be engaged to audit the current year financial statements~~ **the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review**.

- **If you are testing in the July-August 2011 exam window**, disregard the language in boldface italics. Know the remainder, including the language shown by strikethrough.
- **If you are testing in the October-November 2011 exam window**, both the previous and the new guidance is testable. The previous guidance is shown by strikethrough.
- **Beginning with the January-February 2012 exam window, only the new guidance is testable; simply disregard the language shown by strikethrough.**

RECENTLY RELEASED AICPA QUESTIONS AND ANSWERS

In May 2011, the AICPA released fifty multiple-choice questions, two task-based simulations, and 1 research task relating to the AUD section of the CPA Examination. These questions and their unofficial answers are reproduced here as received from the AICPA examiners, along with the Bisk Education's explanations. The multiple-choice questions in Problems 1 and 2 were labeled *medium* and *hard*, respectively, by the AICPA examiners. 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.

Problem 1 MULTIPLE-CHOICE QUESTIONS

1. A primary objective of analytical procedures used in the final review stage of an audit is to
   a. Identify account balances that represent specific risks relevant to the audit
   b. Gather evidence from tests of details to corroborate financial statement assertions
   c. Detect fraud that may cause the financial statements to be misstated
   d. Assist the auditor in evaluating the overall financial statement presentation
   (R/11, AUD, #1, 9901)

2. Which of the following conditions or events most likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern?
   a. Significant related party transactions are pervasive.
   b. Usual trade credit from suppliers is denied.
   c. Arrearages in preferred stock dividends are paid.
   d. Restrictions on the disposal of principal assets are present. (R/11, AUD, #2, 9902)

3. Accepting an engagement to compile a financial projection most likely would be inappropriate if the projection is to be distributed to
   a. The entity's principal stockholder, to the exclusion of the other stockholders
   b. Potential stockholders in an offering statement
   c. A financial institution in a loan application
   d. A state or federal regulatory agency (R/11, AUD, #3, 9903)

4. Which of the following statements extracted from a client's lawyer's letter concerning litigation, claims, and assessments most likely would cause the auditor to request clarification?
   a. "We believe that the possible liability to the company is nominal in amount."
   b. "We believe that the action can be settled for less than the damages claimed."
   c. "We believe that the plaintiff's case against the company is without merit."
   d. "We believe that the company will be able to defend this action successfully."
   (R/11, AUD, #4, 9904)

5. After considering management's plans, an auditor concludes that there is substantial doubt about a client's ability to continue as a going concern for a reasonable period of time. The auditor's responsibility includes
   a. Disclaiming an opinion on the financial statements due to the indications of possible financial difficulties
   b. Indicating to the client's audit committee whether management's plans for dealing with the adverse effects of the financial difficulties can be effectively implemented
   c. Considering the adequacy of disclosure about the client's possible inability to continue as a going concern
   d. Issuing a qualified or adverse opinion, depending upon materiality, due to the possible effects on the financial statements (R/11, AUD, #5, 9905)

6. Which of the following procedures would an auditor most likely perform to obtain evidence about the occurrence of subsequent events?

   a. Determine whether inventory ordered before the year-end was included in the physical count.
   b. Inquire about payroll checks that were recorded before year-end but cashed after year-end.
   c. Investigate changes in capital stock recorded after year-end.
   d. Review tax returns prepared by management after year-end. (R/11, AUD, #6, 9906)

7. When an auditor decides to confirm accounts receivable balances rather than individual invoices, it most likely would be beneficial to include with the confirmations

   a. Copies of the client's shipping documents that support the account balances
   b. Lists of the customers' recent payments that the client has already recorded
   c. Client-prepared statements of account that show the details of the account balances
   d. Copies of the customers' purchase orders that support the account balances
   (R/11, AUD, #7, 9907)

8. A CPA is reporting on comparative financial statements of a nonissuer. The CPA audited the prior year's financial statements and reviewed those of the current year in accordance with Statements on Standards for Accounting and Review Services (SSARS). The CPA has added a separate paragraph to the review report to describe the responsibility assumed for the prior year's audited financial statements. This separate paragraph should indicate

   a. The type of opinion expressed previously
   b. That the CPA did not update the assessment of control risk
   c. The reasons for the change from an audit to a review
   d. That the audit report should no longer be relied on (R/11, AUD, #8, 9908)

9. A CPA started to audit the financial statements of a nonissuer. After completing certain audit procedures, the client requested the CPA to change the engagement to a review because of a scope limitation. The CPA concludes that there is reasonable justification for the change. Under these circumstances, the CPA's review report should include a

   a. Statement that a review is substantially less in scope than an audit
   b. Reference to the scope limitation that caused the changed engagement
   c. Description of the auditing procedures that were completed before the engagement was changed
   d. Reference to the CPA's justification for agreeing to change the engagement
   (R/11, AUD, #9, 9909)

10. Before accepting an engagement to audit a new client, a CPA is required to obtain

    a. An assessment of fraud risk factors likely to cause material misstatements
    b. An understanding of the prospective client's industry and business
    c. The prospective client's signature to a written engagement letter
    d. The prospective client's consent to make inquiries of the predecessor, if any
    (R/11, AUD, #10, 9910)

11. The purpose of tracing a sample of inventory tags to a client's computerized listing of inventory items is to determine whether the inventory items

    a. Represented by tags were included on the listing
    b. Included on the listing were properly counted
    c. Represented by tags were reduced to the lower of cost or market
    d. Included in the listing were properly valued (R/11, AUD, #11, 9911)

12. Which of the following activities is an analytical procedure an auditor would perform in the final overall review stage of an audit to ensure that the financial statements are free from material misstatement?
    a. Reading the minutes of the board of directors' meetings for the year under audit
    b. Obtaining a letter concerning potential liabilities from the client's attorney
    c. Comparing the current year's financial statements with those of the prior year
    d. Ensuring that a representation letter signed by management is in the file
    (R/11, AUD, #12, 9912)

13. A CPA audits the financial statements of a client. The CPA has also been asked to perform bookkeeping functions for the client. Under the AICPA Code of Professional Conduct, which of the following activities would impair the CPA's independence with respect to the client?
    a. The CPA records transactions in accordance with classifications determined by management.
    b. The CPA prepares financial statements from a trial balance provided by management.
    c. The CPA posts adjusting journal entries prepared by management to the trial balance.
    d. The CPA authorizes client transactions and reports them to management.
    (R/11, AUD, #13, 9913)

14. Which of the following actions should a CPA firm take to comply with the AICPA's quality control standards?
    a. Establish procedures that comply with the standards of the Sarbanes-Oxley Act.
    b. Use attributes sampling techniques in testing internal controls.
    c. Consider inherent risk and control risk before determining detection risk.
    d. Establish policies to ensure that the audit work meets applicable professional standards.
    (R/11, AUD, #14, 9914)

15. After an audit report is issued, an auditor discovers that an important audit procedure was not performed. Which of the following procedures is acceptable in this situation?
    a. No further action is necessary if the audit report can still be supported.
    b. Let the current report stand and correct material errors on the next audit report.
    c. Immediately notify known users of the omitted audit procedure.
    d. Require that the client notify financial statements users of the omitted procedures.
    (R/11, AUD, #15, 9915)

16. An auditor has identified the controller's review of the bank reconciliation as a control to test. In connection with this test, the auditor interviews the controller to understand the specific data reviewed on the reconciliation. In addition, the auditor verifies that the bank reconciliation is properly prepared by the accountant and reviewed by the controller as evidenced by their respective sign-offs. Which of the following types of audit procedures do these actions illustrate?
    a. Observation and inspection of records
    b. Confirmation and reperformance
    c. Inquiry and inspection of records
    d. Analytical procedures and reperformance (R/11, AUD, #16, 9916)

17. Which of the following is a definition of control risk?
    a. The risk that a material misstatement will not be prevented or detected on a timely basis by the client's internal controls.
    b. The risk that the auditor will not detect a material misstatement.
    c. The risk that the auditor's assessment of internal controls will be at less than the maximum level.
    d. The susceptibility of material misstatement assuming there are no related internal controls, policies, or procedures. (R/11, AUD, #17, 9917)

18. Which of the following is **not** a component of internal control?

    a. Control environment
    b. Control activities
    c. Inherent risk
    d. Monitoring (R/11, AUD, #18, 9918)

19. Prior to, or in conjunction with, the information-gathering procedures for an audit, audit team members should discuss the potential for material misstatement due to fraud. Which of the following best characterizes the mind-set that the audit team should maintain during this discussion?

    a. Presumptive
    b. Judgmental
    c. Criticizing
    d. Questioning (R/11, AUD, #19, 9919)

20. Each of the following types of controls is considered to be an entity-level control, **except** those

    a. Relating to the control environment
    b. Pertaining to the company's risk assessment process
    c. Regarding the company's annual stockholder meeting
    d. Addressing policies over significant risk management practices (R/11, AUD, #20, 9920)

21. Which of the following statements would **not** normally be included in a representation letter for a review of interim financial information?

    a. To the best of our knowledge and belief, no events have occurred subsequent to the balance sheet and through the date of this letter that would require adjustment to or disclosure in the interim financial information.
    b. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
    c. We understand that a review consists principally of performing analytical procedures and making inquiries about the interim financial information.
    d. We have made available to you all financial records and related data. (R/11, AUD, #21, 9921)

22. When performing a review of interim financial information, an accountant would typically do each of the following, **except**

    a. Consider the results from the latest audit
    b. Test controls related to the preparation of annual financial information
    c. Perform analytical procedures
    d. Make inquiries of management (R/11, AUD, #22, 9922)

23. Which of the following is a correct statement regarding the nature and timing of communications between an accounting firm performing an initial audit of an issuer and the issuer's audit committee?

    a. Prior to accepting the engagement, the firm must orally affirm its independence to the audit committee with all members present.
    b. The firm must address all independence impairment issues on the date of the audit opinion.
    c. Communications related to independence may occur in any form prior to issuance of the financial statements.
    d. Prior to accepting the engagement, the firm should describe in writing all relationships that, as of the date of the communication, may reasonably be thought to bear on independence. (R/11, AUD, #23, 9923)

24. A person identified as an audit committee financial expert of an issuer generally must have acquired the attributes of a financial expert through any of the following experiences, **except**

    a. As a principal financial officer, principal accounting officer, controller, public accountant, or auditor
    b. Serving on at least one other issuer's audit committee or disclosure committee of the board of directors
    c. Actively supervising a principal financial officer or principal accounting officer
    d. Assessing the performance of public accountants with respect to preparation, auditing, or evaluation of financial statements (R/11, AUD, #24, 9924)

25. An issuer may hire an employee of a registered public accounting firm who served on the audit engagement team within the previous year for which of the following positions?

    a. Controller
    b. CFO
    c. CEO
    d. Staff accountant (R/11, AUD, #25, 9925)

Problem 2 ADDITIONAL MULTIPLE-CHOICE QUESTIONS

26. An entity's comparative financial statements include the financial statements of the prior year that were audited by a predecessor auditor whose report is not presented. If the predecessor's report was qualified, the successor should

    a. Issue an updated comparative audit report indicating the division of responsibility.
    b. Explain to the client that comparative financial statements may not be presented under these circumstances.
    c. Express an opinion only on the current year's financial statements and make no reference to the prior year's statements.
    d. Indicate the substantive reasons for the qualification in the predecessor auditor's opinion.
    (R/11, AUD, #26, 9926)

27. How does an auditor make the following representations when issuing the standard auditor's report on comparative financial statements?

	Consistent application of accounting principles	*Examination of evidence on a test basis*
a.	Implicitly	Explicitly
b.	Explicitly	Implicitly
c.	Implicitly	Implicitly
d.	Explicitly	Explicitly

(R/11, AUD, #27, 9927)

28. As a condition of obtaining a loan from First National Bank, Maxim Co. is required to submit an audited balance sheet but not the related statements of income, retained earnings, or cash flows. Maxim would like to engage a CPA to audit only its balance sheet. Under these circumstances, the CPA

    a. May not audit only Maxim's balance sheet if the amount of the loan is material to the financial statements taken as a whole
    b. May not audit only Maxim's balance sheet if Maxim is a nonissuer
    c. May audit only Maxim's balance sheet if the CPA disclaims an opinion on the other financial statements
    d. May audit only Maxim's balance sheet if access to the information underlying the basic financial statements is not limited (R/11, AUD, #28, 9928)

29. Which of the following statements is correct concerning analytical procedures used in planning an audit engagement?
    a. They often replace the tests of controls that are performed to assess control risk.
    b. They usually use financial and nonfinancial data aggregated at a high level.
    c. They usually involve the comparison of assertions developed by management to ratios calculated by an auditor.
    d. They are often used to develop an auditor's preliminary judgment about materiality.
    (R/11, AUD, #29, 9929)

30. Which of the following statements is ordinarily correct about the sample size in statistical sampling when testing controls?
    a. The expected population deviation rate has little effect on determining the sample size.
    b. As the population size doubles, the sample size should also double.
    c. As the tolerable deviation rate increases, the sample size should also increase.
    d. The population size has little effect on the sample size. (R/11, AUD, #30, 9930)

31. Which of the following statements is correct regarding internal control?
    a. A well-designed internal control environment ensures the achievement of an entity's control objectives.
    b. An inherent limitation to internal control is the fact that controls can be circumvented by management override.
    c. A well-designed and operated internal control environment should detect collusion perpetrated by two people.
    d. Internal control is a necessary business function and should be designed and operated to detect all errors and fraud. (R/11, AUD, #31, 9931)

32. General Retailing, a nonissuer, has asked Ford, CPA, to compile its financial statements that omit substantially all disclosures required by GAAP. Ford may comply with General's request provided the omission is clearly indicated in Ford's report and the
    a. Distribution of the financial statements and Ford's report is restricted to internal use only.
    b. Reason for omitting the disclosures is acknowledged in the notes to the financial statements.
    c. Omitted disclosures would not influence any potential creditor's conclusions about General's financial position.
    d. Omission is not undertaken with the intention of misleading the users of General's financial statements. (R/11, AUD, #32, 9932)

33. When assessing internal auditors' objectivity, an independent auditor should
    a. Consider the policies that prohibit the internal auditors from auditing areas where they were recently assigned.
    b. Review the internal auditors' reports to determine that their conclusions are consistent with the work performed.
    c. Verify that the internal auditors' assessment of control risk is comparable to the independent auditor's assessment.
    d. Evaluate the quality of the internal auditors' working paper documentation and their recent audit recommendations. (R/11, AUD, #33, 9933)

34. During a financial statement audit an internal auditor may provide direct assistance to the independent CPA in performing

	Tests of Controls	*Substantive tests*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

(R/11, AUD, #34, 9934)

35. In auditing contingent liabilities, which of the following procedures would an auditor most likely perform?

    a. Confirm the details of outstanding purchase orders.
    b. Apply analytical procedures to accounts payable.
    c. Read the minutes of the board of directors' meetings.
    d. Perform tests of controls on the cash disbursement activities. (R/11, AUD, #35, 9935)

36. An auditor believes there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. In evaluating the entity's plans for dealing with the adverse effects of future conditions and events, the auditor most likely would consider, as a mitigating factor, the entity's plans to

    a. Purchase production facilities currently being leased from a third party.
    b. Postpone expenditures to upgrade its information technology system.
    c. Pay cash dividends that are in arrears to the preferred stockholders.
    d. Increase the useful lives of plant assets for depreciation purposes. (R/11, AUD, #36, 9936)

37. An auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. The entity's financial statements adequately disclose its financial difficulties. Under these circumstances, the auditor's report is required to include an explanatory paragraph that specifically uses the phrase(s)

	"Except for the effects of such adjustments"	*"Possible discontinuance of the entity's operations"*	
a.	Yes	Yes	
b.	Yes	No	
c.	No	Yes	
d.	No	No	(R/11, AUD, #37, 9937)

38. After issuing an auditor's report, an auditor becomes aware of facts that existed at the report date that would have affected the report had the auditor known of the facts at the time. What is the first thing the auditor should do?

    a. Notify each member of the board of directors that the auditor's report may not be associated with the financial statements from this point forward.
    b. Issue revised financial statements and auditor's report describing the reason for the revision in a note to the financial statements.
    c. Determine whether there are persons currently relying on, or likely to rely on, the financial statements and whether those persons would attach importance to the information.
    d. Notify regulatory agencies having jurisdiction over the client that the auditor's report should not be relied upon from this point forward. (R/11, AUD, #38, 9938)

39. A portion of a client's inventory is in public warehouses. Evidence of the existence of this merchandise can most efficiently be acquired through which of the following methods?

    a. Observation
    b. Confirmation
    c. Calculation
    d. Inspection (R/11, AUD, #39, 9939)

40. A company hires one of its board members, a CPA, to issue accounting reports for the company. Assuming any required disclosures are made, which of the following reports may the CPA issue without violating independence rules?

    a. Compilations
    b. Reviews
    c. Audits
    d. Agreed-upon procedures (R/11, AUD, #40, 9940)

41. A CPA purchased stock in a client corporation and placed it in a trust as an educational fund for the CPA's minor child. The trust securities are not material to the CPA's wealth but are material to the child's personal net worth. According to the AICPA Code of Professional Conduct, would this action impair the CPA's independence with the client?

    a. No, because the CPA would not have a direct financial interest in the client.
    b. Yes, because the stock would be a direct financial interest and materiality is a factor.
    c. Yes, because the stock would be an indirect financial interest and materiality is not a factor.
    d. Yes, because the stock would be a direct financial interest and materiality is not a factor.

    (R/11, AUD, #41, 9941)

42. Which of the following analytical procedures most likely would be used during the planning stage of an audit?

    a. Comparing current year to prior year sales volumes
    b. Reading the financial statements and notes and considering the adequacy of evidence
    c. Comparing the current year ratio of aggregate salaries paid to the number of employees to the prior year's ratio
    d. Reading the letter from the client's attorney and considering the threat of litigation

    (R/11, AUD, #42, 9942)

43. Which of the following should an auditor do when control risk is assessed at the maximum level?

    a. Perform fewer substantive tests of details.
    b. Perform more tests of controls.
    c. Document the assessment.
    d. Document the control structure more extensively. (R/11, AUD, #43, 9943)

44. The company being audited has an internal auditor that is both competent and objective. The independent auditor wants to assign tasks for the internal auditor to perform. Under these circumstances, the independent auditor may

    a. Allow the internal auditor to perform tests of internal controls.
    b. Allow the internal auditor to audit a major subsidiary of the company.
    c. Not assign any task to the internal auditor because of the internal auditor's lack of independence
    d. Allow the internal auditor to perform analytical procedures, but not be involved with any tests of details. (R/11, AUD, #44, 9944)

45. An auditor discovers that an account balance believed not to be materially misstated based on an audit sample was materially misstated based on the total population of the account balance. This is an example of which of the following sampling types of risks?

    a. Incorrect rejection
    b. Incorrect acceptance
    c. Assessing control risk too low
    d. Assessing control risk too high (R/11, AUD, #45, 9945)

46. According to the AICPA Code of Professional Conduct, which of the following actions by a CPA most likely involves an act discreditable to the profession?

    a. Refusing to provide the client with copies of the CPA's workpapers
    b. Auditing financial statements according to governmental standards despite the client's preferences
    c. Accepting a commission from a nonattest function client
    d. Retaining client records after the client demands their return (R/11, AUD, #46, 9946)

47. When planning a review of an audit client's interim financial statements, which of the following procedures should the accountant perform to update the accountant's knowledge about the entity's business and its internal control?
    a. Perform analytical procedures on selected accounts by comparing the interim amounts to the amounts for the previous audited fiscal year-end.
    b. Inquire of the entity's outside legal counsel about the status of any previous pending litigation and any new litigation involving the entity.
    c. Select a sample of material revenue transactions occurring during the interim period and examine supporting documentation.
    d. Consider the results of audit procedures performed with respect to the current year's financial statements. (R/11, AUD, #47, 9947)

48. An accountant has been engaged to compile *pro forma* financial statements. During the accountant's acceptance procedures, it is discovered that the accountant is not independent with respect to the company. What action should the accountant take with regard to the compilation?
    a. The accountant should discuss the lack of independence with legal counsel to determine whether it is appropriate to accept the engagement.
    b. The accountant should disclose the lack of independence in the accountant's compilation report.
    c. The accountant should withdraw from the engagement.
    d. The accountant should compile the *pro forma* financial statements but should not provide a compilation report. (R/11, AUD, #48, 9948)

49. In an accountant's review of interim financial information, the accountant typically performs each of the following, **except**
    a. Reading the available minutes of the latest stockholders' meeting
    b. Applying financial ratios to the interim financial information
    c. Inquiring of the accounting department's management
    d. Obtaining corroborating external evidence (R/11, AUD, #49, 9949)

50. According to the SEC, an auditor is **not** independent of its issuer audit client in which of the following situations?
    a. The auditor's cousin has an insurance policy obtained from the issuer before it became an audit client.
    b. The auditor has an automobile loan at standard terms from the audit client that is collateralized by the automobile.
    c. The auditor has an investment in an entity that has the ability to exercise significant influence over the audit client.
    d. The auditor's grandparent was in an accounting role at the audit client and ended employment before the period under audit began. (R/11, AUD, #50, 9950)

Problem 3-1 SIMULATION: Accounts Receivable (AR) Confirmations

The auditor requested the company's aged accounts receivable schedule listing the total amount owed by each customer as of December 31, year 2. The audit team sent the following positive confirmation requests to a sample of the company's customers.

Confirmation Letters

February 15, year 3

Chip Technology
500 E. Fifth Street
Cincinnati, OH 45202

Re: Balance at December 31, year 2 - $95,000

Dear Sirs:

As of December 31, year 2, our records indicate that you have a balance due to our company in the amount listed above. Please complete and sign the bottom portion of this letter, and return the entire letter to our auditors, Whisp, LLP, P.O. Box 100, Cleveland, Ohio 44115.

A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

__________Jim Johnston_______
Company Controller

The above balance is [ ] Correct

[X] Incorrect (show amount) $92,000

If incorrect, please provide information that could help to reconcile your account.

Recipient's Comment: Our records indicate that check #45998 for $3,000 was mailed on December 24, year 2.

Sue Smith	AP Supervisor	3/2/year 3
Signature	Title	Date

Auditor's note to file:

Per discussion with the controller, this customer's payment was received on December 28, but was not processed until January 4.

February 15, year 3

BiCon Semiconductor
8700 West Ave.
Rockland, KY 46009

Re: Balance at December 31, year 2 - $66,700

Dear Sirs:

As of December 31, year 2, our records indicate that you have a balance due to our company in the amount listed above. Please complete and sign the bottom portion of this letter, and return the entire letter to our auditors, Whisp, LLP, P.O. Box 100, Cleveland, Ohio 44115.

A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

__________Jim Johnston_______
Company Controller

The above balance is [ ] Correct

[ ] Incorrect (show amount) _______

If incorrect, please provide information that could help to reconcile your account.

Recipient's Comment: *Blank*

Signature	Title	Date

Auditor's note to file:

This confirmation was returned by the postal service as "return to sender—no such addressee at this location." This was the second attempt to reach the customer.

February 15, year 3

Whistler's Computer Warehouse
700 – 800 Adams St.
Newport, CT 11223

Re: Balance at December 31, year 2 - $120,050

Dear Sirs:

As of December 31, year 2, our records indicate that you have a balance due to our company in the amount listed above. Please complete and sign the bottom portion of this letter, and return the entire letter to our auditors, Whisp, LLP, P.O. Box 100, Cleveland, Ohio 44115.

A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

Jim Johnston
Company Controller

The above balance is [ ] Correct

[X] Incorrect (show amount) $118,050

If incorrect, please provide information that could help to reconcile your account.

Recipient's Comment: The materials from invoice #145 were returned on December 12, year 2.

Warren C. Worth	AP Supervisor	2/25/year 3
Signature	Title	Date

Auditor's note to file:

Firm confirmed this with the A/R supervisor.

February 15, year 3

Digital Digits
15 8th Ave.
Washington, OR 78899

Re: Balance at December 31, year 2 - $2,000,000

Dear Sirs:

As of December 31, year 2, our records indicate that you have a balance due to our company in the amount listed above. Please complete and sign the bottom portion of this letter, and return the entire letter to our auditors, Whisp, LLP, P.O. Box 100, Cleveland, Ohio 44115.

A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

Jim Johnston
Company Controller

The above balance is [ ] Correct

[X] Incorrect (show amount) $2,760,000

If incorrect, please provide information that could help to reconcile your account.

Recipient's Comment: In addition, we have invoices #A1768 ($360,000) & A1769 ($400,000), but I'm not sure when they are from.

Darlene Dunham	AP Supervisor	3/5/year 3
Signature	Title	Date

Auditor's note to file:

Blank.

February 15, year 3

Rockford's
37 73rd Street
Leder, VA 39281

Re: Balance at December 31, year 2 - $1,288,698

Dear Sirs:

As of December 31, year 2, our records indicate that you have a balance due to our company in the amount listed above. Please complete and sign the bottom portion of this letter, and return the entire letter to our auditors, Whisp, LLP, P.O. Box 100, Cleveland, Ohio 44115.

A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

__________Jim Johnston_______
Company Controller.

The above balance is [X] Correct

[ ] Incorrect (show amount) $______

If incorrect, please provide information that could help to reconcile your account.

Recipient's Comment: Please be aware that as of March 1, we are changing our name to Richards' Service and Support.

Signature	Title	Date

Auditor's note to file:

Blank

February 15, year 3

Jungle Applications
1200 East End Drive
Richelieu, KY 18998

Re: Balance at December 31, year 2 - $40,000

Dear Sirs:

As of December 31, year 2, our records indicate that you have a balance due to our company in the amount listed above. Please complete and sign the bottom portion of this letter, and return the entire letter to our auditors, Whisp, LLP, P.O. Box 100, Cleveland, Ohio 44115.

A stamped, self-addressed envelope is enclosed for your convenience.

Sincerely,

__________Jim Johnston_______
Company Controller

The above balance is [ ] Correct

[ ] Incorrect (show amount) $______

If incorrect, please provide information that could help to reconcile your account.

Recipient's Comment: Sorry for the inconvenience, but our A/P system is unable to confirm balances unless we have purchase order numbers.

Julie Ashton	AP Supervisor	2/26/year 3
Signature	Title	Date

Auditor's note to file:

Blank

Review the confirmations and subsequent comments at the bottom of each confirmation and determine the action required for each one. Select the best action to follow from the selection list below. Choose only one action per confirmation. An action may be used once, more than once, or not at all.

Customer	Action Required
A. Chip Technology	
B. BiCon Semiconductor	
C. Whistler's Computer Warehouse	
D. Digital Digits	
E. Rockford's	
F. Jungle Applications	

Selection List

1. Exception noted; propose adjustment and request that the controller post it to the accounting records.	4. Verify by examining shipping documents and subsequent cash collections.
2. Send a second request for confirmation to the customer.	5. Verify that additional invoices noted on confirmation pertain to the subsequent year.
3. Trace to open sales order detail as of December 31, year 2.	6. Not an exception, no further audit work deemed necessary.

(R/11, AUD, 9832)

Problem 3-2 SIMULATION: Audit Test and Purpose

For each of the descriptions of procedures in column a of the table below, select the audit procedure performed from the selection list for column b and then indicate in column c whether it was a substantive procedure or a test of controls. Selections may be used once, more than once, or not at all.

a	b	c
Description of Procedure	**Audit Procedure Performed**	**Classification of Audit Procedure**
A. Examined sales invoices to see if they were initialed by the credit manager indicating credit approval.		
B. Compared this year's expenses with last year's expenses and investigated unusual fluctuations.		
C. Requested responses directly from customers.		
D. Questioned management about subsequent events.		
E. Observed the accounting clerk record the daily deposit of cash receipts.		
F. Examined invoices to support additions to the fixed asset account during the year.		
G. Agreed sales invoices to credit files to determine whether the customer had a credit file and had been approved for credit.		
H. Asked the accounting manager how often cash is deposited and by whom.		

Selection List of Audit Procedures Performed

1. Analytical procedure	6. Monitoring
2. Confirmation	7. Observation
3. Disclosure	8. Recalculation
4 Inquiry	9. Reperformance
5. Inspection	

Selection List of Classifications of Audit Procedure

1. Substantive procedures	2. Tests of controls

(R/11, AUD, 9833)

Problem 3-3 SIMULATION: Research

During year 2, the company hired several internal auditors to fill positions that had been vacant for three years. Which section of the auditing standards addresses the inquiries that the independent auditor should make of the internal audit personnel regarding the risks of fraud?

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 the exam section of their Web site.

	§			(R/11, AUD, 9934)

Solution 1 MULTIPLE-CHOICE ANSWERS

1. (d) The objective of analytical procedures used in the overall review stage of an audit is to *assist the auditor* in assessing the conclusions reached and *in the evaluation of the overall financial statement presentation*. GAAS require that analytical procedures be applied to some extent for assisting the auditor in planning the nature, extent, and timing of other auditing procedures and as an overall review of the financial information in the final review stage of the audit. Analytical procedures can be, but are not required to be, used as a substantive test during an audit to gather evidence about particular assertions related to account balances or classes of transactions. Identifying account balances that represent specific risks relevant to the audit or detecting fraud that may cause the statements to be misstated are objectives of analytics during the planning, not the final review, stage of the audit. Gathering evidence from tests of details to corroborate financial statement assertions is an objective of using analytical procedures as a substantive test. (Chapter 24-IV-B; 9901; CSO: IV.A.0)

2. (b) The auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The *denial of usual trade credit from suppliers* is an example of an indicator of possible financial difficulties. Significant and pervasive related party transactions may be motivated by the lack of sufficient working capital or credit to continue the business or other adverse conditions; however, this is not as strong an indicator as the denial of trade credit from suppliers. (In the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business.) Generally, payment of arrearages in preferred stock dividends would be a positive indicator of financial health. The presence of restrictions on the disposal of principal assets may be due to contractual or regulatory requirements or simply a part of an entity's internal control policies—it is not an indicator of doubt about an entity's ability to continue as a going concern. (Chapter 28-IX-C; 9902; CSO: IV.G.0)

3. (b) A CPA should not accept an engagement if the CPA's name will be used in conjunction with a financial projection that will be distributed to those who will not be negotiating directly with the responsible party (unless the projection is used to supplement a financial forecast which was not indicated by this question). The responsible party is the person(s) who are responsible for the assumptions underlying the prospective financial information. The responsible party is usually management, but it can be persons outside the entity, for example, a party considering acquiring the entity. The attestation standards for prospective financial statements distinguish between forecasts and projections. Relevant to this question, a financial projection is not appropriate for general use. General use refers to the use of the statements by persons with whom the responsible party is not negotiating directly, for example, in an *offering statement of an entity's debt or equity interests*. Because recipients of prospective financial statements distributed for general use are unable to ask the responsible party directly about the presentation, the presentation most useful to them is one that portrays, to the best of the responsible party's knowledge and belief, the expected results. Thus, only a financial forecast is appropriate for general use. Limited use refers to the use of the statements by the responsible party alone or by the responsible party and third parties with whom the responsible party is negotiating directly. Examples include use in negotiations for a bank loan, submission to a regulatory agency (submission to a regulatory agency is considered limited use even though, by law or regulation, it may be a matter of public record), and use solely within the entity. Thus, the other answer alternatives describe acceptable engagements as long as the report includes an appropriately worded restriction. (Chapter 31-IV-B; 9903; CSO: I.B.5.)

4. (b) The letter requests the attorney to provide an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss concerning litigation, claims, and assessments. The statement that it is the attorney's belief that the action can be settled for less than the damages claimed begs for a follow-up question (clarification) as to whether an estimate of how much less can be made; the other answer alternatives are definitive responses. (Chapter 24-VI-B; 9904; CSO: III.B.17.)

5. (c) When, after considering management's plans, the auditor concludes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, the auditor should consider the possible effects on the financial statements and *the adequacy of the related disclosure*. The auditor may choose to disclaim an opinion, but it is not a requirement, i.e., a responsibility. It is also not the auditor's responsibility to indicate to the client's audit committee whether management's plans for dealing with adverse effects of the financial difficulties can be effectively implemented. (The auditor does consider whether such plans can be effectively implemented for the purposes on determining if disclosure is adequate and the effect on the audit report.) The auditor should communicate with those charged with governance (1) the nature of the events or conditions identified; (2) the possible effect on the financial statements and the adequacy of related disclosures in the financial statements; and (3) the effects on the auditor’s report. The audit report should include an explanatory paragraph (following the opinion paragraph) to reflect the conclusion that there is substantial doubt; i. e., issue a modified unqualified opinion; not a qualified or adverse opinion, depending on the materiality. A qualified or adverse opinion should be issued if the related disclosure is inadequate. The question did not indicate that was the case. (Chapter 28-IX-E; 9905; CSO: IV.J.1.)

6. (c) An auditor should perform auditing procedures with respect to the period after the balance sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure. These procedures should be performed at or near the date of the auditor’s report. For, example, the auditor generally should inquire of and discuss with officers and other executives having responsibility for financial and accounting matters as to whether there was any significant *change in the capital stock*, long-term debt, or working capital to the date of inquiry. The determination of the whether inventory ordered before the year-end was included in the physical count as well as inquiries about payroll checks recorded before year-end but cashed after year-end are examples of procedures to determine proper cutoff, not the occurrence of subsequent events. A review of tax returns prepared after year-end would generally not be as likely to reveal the occurrence of subsequent events as would changes in capital stock after year-end. (Chapter 28-VII-B; 9906; CSO: III.B.18.)

7. (c) The inclusion of client-prepared statements (that show the details of the account balance) with the confirmation requests would most likely prove beneficial, i.e., improve the response rate. Copies of shipping documents or purchase orders would not be as beneficial as a detailed statement tied to the actual account balance. Shipping documents often do not include the cost of the goods shipped. Prices included on purchase orders are generated by the client's customers rather than the client and thus may not be current or include applicable or correct discounts. Also, individual purchase orders may include items that were back-ordered by your client and thus not yet billed, i.e., not part of the current account balance. Lists of the customer's recent payments that the client has already recorded would not be included in the account balance and thus, are irrelevant—the purpose of the confirmation process is to confirm unpaid amounts. (Chapter 25-III-B; 9907; CSO: III.B.8.)

8. (a) When the current period financial statements of a nonissuer have been compiled or reviewed and those of the prior period have been audited, the CPA should issue an appropriate compilation or review report on the current period financial statements and either the report on the prior period should be reissued or the report on the current period should include, as a separate paragraph, an appropriate description of the responsibility assumed for the financial statements of the prior period. In the latter case, the separate paragraph should indicate (1) that the financial statements of the prior period were audited previously; (2) the date of the previous report; (3) *the type of opinion expressed previously*; (4) if the opinion was other than unqualified, the substantive reasons; and (5) that no auditing procedures were performed after the date of the previous report. The other answer alternatives should not be included. (Chapter 31-II-E; 9908; CSO: V.C.2.)

9. (a) When a CPA concludes that there is reasonable justification to change the engagement, the CPA should comply with the standards applicable to a review engagement and issue an appropriate review report which would include a *statement that a review is substantially less in scope than an audit*, the objective of which is the expression of an opinion regarding the financial statements as a whole, and that, accordingly, the accountant does not express such an opinion. The report should not include reference to the original engagement (reference to the CPA's justification for agreeing to change the

engagement would include reference to the original engagement); any audit procedures that may have been performed; or scope limitations that resulted in the changed engagement. (Chapter 31-I-C; 9909; CSO: V.A.4.)

10. (d) The successor auditor should request permission from the prospective client to make an inquiry of the predecessor auditor prior to final acceptance of the engagement. The other answer alternatives describe activities that are not required *prior* to the acceptance of an engagement (an understanding of the client's industry and business *or the ability to gain it* is required). **Editor note**: The answer designated as correct by the AICPA states: The prospective client's consent to make inquiries of the predecessor, if any. Inquiry of the predecessor auditor before acceptance of an engagement is required; thus, the inclusion of the phrase *if any* is inappropriate. (Chapter 21-V-B; 9910; CSO: I.C.0)

11. (a) The purpose of tracing a sample of inventory tags to a client's computerized listing of inventory items is to determine whether the inventory items *represented by the tags were included on the listing*. It is a way of testing the assertion of completeness. The other answer alternatives are objectives that would not be accomplished by the procedure as described in the question. (Chapter 25-III-C; 9911; CSO: III.B.9.)

12. (c) Only *comparing the current year's financial statements with those of the prior year* is a description of an analytical procedure. Although analytics involve evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data, the other answer alternatives which refer to nonfinancial information do not describe a review of relationships of financial information with relevant nonfinancial information. Additionally, obtaining a letter from the client's attorney should be obtained prior to the final review stage. (Chapter 24-IV-A; 9912; CSO: IV.A.0)

13. (d) Under the AICPA Code of Professional Conduct, Rule 101-3 states that the CPA’s independence with respect to the client would be impaired if the CPA authorized or approved transactions. The CPA’s independence would not be impaired if they recorded transactions in accordance with classifications determined by management, prepared financial statements from a trial balance provided by management, or posted journal entries prepared by management to the trial balance. (Chapter 32-I-C; 9913; CSO: VI.A.1.)

14. (d) GAAS require a firm of independent auditors to adopt a system of quality control in conducting an audit practice. Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance that its personnel comply with generally accepted auditing standards in its audit engagements. Further, the AICPA's quality control standards require that a CPA firm establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. A system of quality control consists of policies designed to achieve these objectives and the procedures necessary to implement and monitor compliance with those policies. The best answer is *establish policies to ensure that the audit work meets applicable professional standards*. Compliance with the Sarbanes-Oxley Act is too limited; is not applicable to all firms; and does not encompass the AICPA's quality control standards. The other answer alternatives are not on point. (Chapter 21-IV-A; 9914; CSO: I.B.1.)

15. (a) When an auditor concludes that an auditing procedure considered necessary at the time of the audit was omitted (after an audit report is issued), the auditor should assess the importance of the omitted procedure to the auditor's present ability to support the audit report. For example, the results of other procedures that were applied may tend to compensate for the one omitted or make its omission less important. Also, subsequent audits may provide audit evidence in support of the previously expressed opinion. *No further action is necessary if the audit report can still be supported*. Letting the current report stand and correcting material errors on the next audit report is not an option. The auditor should first determine if the report can still be supported and if it cannot, the omitted or alternative procedures should be applied that would provide a satisfactory basis for the opinion; thus, the auditor would not immediately notify known users. Only when as a result of the subsequent application of the omitted procedure or alternative procedures, the auditor becomes aware that facts regarding the financial statements existed at the date of the audit report that would have affected that report had the auditor been aware of them and

the auditor believes there are persons currently relying or likely to rely on the financial statements who would attach importance to the information, would the auditor advise the client to make the appropriate disclosure of the facts (not the omitted procedure) and the impact on the financial statements to such users. If the client refuses to do so, the auditor should take steps to prevent future reliance on the audit report. (If the auditor is unable to apply the previously omitted procedure or alternative procedures, the auditor should consult an attorney to determine an appropriate course of action concerning the auditor's responsibilities to the client, regulatory authorities, if any, having jurisdiction over the client, and persons relying, or likely to rely, on the audit report.) (Chapter 28-VII-D; 9915; CSO: IV.J.14.)

16. (c) The question describes the inquiry and inspection of records. It describes the auditor interviewing the controller (making inquiries) and inspecting the records (the verification that the reconciliation was properly prepared and included appropriate sign-offs) after the procedure had taken place, so it was not observation. The auditor did not perform the control procedure (the reconciliation) so it wasn't reperformance. And no analytical procedures are described. (Chapter 23-III-B; 9916; CSO: III.B.4.)

17. (a) Control risk is the risk that a *misstatement* that could occur in a relevant assertion and that could be *material*, either individually or when aggregated with other misstatements, *will not be prevented or detected on a timely basis by the entity's internal control*. The risk that the auditor will not detect a material misstatement is detection risk. The risk that the auditor's assessment of internal controls will be at less than the maximum level is not a risk—the use of risk assessment procedures and tests of controls may appropriately result in such a conclusion. The susceptibility of material misstatement assuming there are no related internal controls, policies, or procedures is inherent risk. (Chapter 22-II-E; 9917; CSO: II.F.5.)

18. (c) Inherent risk is not one of the components of internal control; rather, along with control risk it is a component of the risk of material misstatement. Internal control consists of five interrelated components: (1) control environment; (2) risk assessment; (3) information and communication systems; (4) control activities; and (5) monitoring. (Chapter 23-I-B; 9918; CSO: II.F.1.)

19. (d) The auditor with final responsibility for the audit should communicate with members of the audit team regarding the susceptibility of the entity’s financial statements to material misstatement due to error or fraud, with special emphasis on fraud. *The discussion should emphasize the need to maintain a questioning mind* and to exercise professional skepticism in gathering and evaluating evidence throughout the audit. The terms judgmental and criticizing are too extreme. A presumptive mind-set in the context of an audit would mean supposing (assuming) conclusions before gathering evidence which is nearly the opposite of the appropriate questioning mind-set. (Chapter 22-I-E; 9919; CSO: II.B.0)

20. (c) Controls regarding the company's annual stockholder meeting are not entity-level. Entity-level controls include: controls related to the control environment; controls over management override of other controls; the company’s risk assessment processes; centralized processing and controls, including shared service environments; controls to monitor results of operations; controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; controls over the period-end financial reporting process; and policies that address significant business control and risk management practices. (Chapter 29-IV-F; 9920; CSO: II.F.1.)

21. (c) Written representations from management ordinarily confirm representations explicitly or implicitly given to the auditor; indicate and document the continuing appropriateness of such representations; and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations. Thus, the statement that *a review consists principally of performing analytical procedures and making inquiries about the interim financial information* is not appropriate for inclusion in a management representation letter; rather, it should be included in the engagement letter to provide information about the CPA's responsibilities. The other answer alternatives are appropriate statements for inclusion in a management representation letter for all reviews. (Chapter 31-I-C; 9921; CSO: V.B.5.)

22. (b) No review, interim or annual, performed according to the SSARS or GAAS for nonissuers or PCAOB audit standards for issuers contemplates testing controls to evaluate their effectiveness. An interim review performed according to GAAS for a nonissuer or PCAOB audit standards for an issuer does require obtaining an understanding of the client's internal control, but does not involve testing controls. The other three answer alternatives would typically be done during a review engagement which consists principally of performing analytical procedures and making inquiries of person responsible for financial and accounting matters. (Chapter 31-I-C; 9922; CSO: V.A.1)

23. (d) Under the Independence Standards Board Statement 1 (ISB 1) the auditor must disclose, in writing, to the audit committee, all relationships between the auditor and its related entities and the client entity and its related entities that, in the auditor's judgment, may be considered to bear on independence. (Chapter 32-I-D; 9923; CSO: VI.A.2)

24. (b) The Sarbanes-Oxley Act of 2002 specifies that an audit committee must contain at least one financial expert. The attributes of a financial expert on the audit committee can be acquired in a number of ways, including; serving as a principal financial officer, principal accounting officer, controller, public accountant, or auditor; actively supervising a principal financial officer or principal accounting officer; or assessing the performance of public accountants with respect to preparation, auditing, or evaluation of financial statements. (Chapter 32-VII-B; 9924; CSO: VI.B.1.)

25. (d) Under the AICPA Code of Professional Conduct, Rule 101-2 independence issues could arise if a professional joins an audit client within one year of disassociating from the audit firm and the professional is in a position to influence the accounting firm's operations or financial policies. Officer positions such as Controller, CFO, and CEO are included in this regard. The position of staff accountant is a lower management position not generally viewed as able to influence the accounting firm's operations or financial policies. (Chapter 32-I-C; 9925; CSO: VI.A.6.)

Solution 2 ADDITIONAL MULTIPLE-CHOICE ANSWERS

26. (d) If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the introductory paragraph of the audit report (1) that the financial statements of the prior period were audited by another auditor; (2) the date of that report; (3) the type of report issued by the predecessor auditor; and (4) *if the report was other than a standard report, the substantive reasons*. The successor auditor does not have the option to issue an updated report on the audit conducted by the predecessor. (An auditor indicates division of responsibility in an audit report when an auditor's opinion on financial statements is based in part on the report of another auditor regarding those same financial statements.) Comparative statements can be presented under the circumstances described in this question as long as the successor auditor includes the information just described about the prior period financial statements and audit report or if the predecessor reissues the audit report on the financial statements of the prior period at the request of the former client and performs the required procedures to determine if the report is still appropriate. (The predecessor should use the date of the previous report on the reissued report unless the report is revised, in which case it should be dual-dated.) The successor auditor should not express an opinion only on the current year's financial statements and make no reference to the prior year's statements. To do so would be a violation of the 4th standard of reporting: *The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report*. Reference in the 4th reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. (Chapter 28-V-D; 9926; CSO: IV.J.1.)

27. (a) The answer is the same for the standard auditor's report for both comparative and single-year financial statements. Consistency is implied (implicit) in the standard report, i.e., if satisfied, the auditor does not refer to consistency in the audit report. The standard audit report states (explicitly) in the scope paragraph that *an audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.* (Chapter 28-V-A; 9927; CSO: IV.J.1.)

28. (d) The auditor may be asked to report on one basic financial statement and not on the others. Such an engagement does not involve a scope limitation *if the auditor's access to information underlying the basic financial statements is not limited* and if the auditor applies all the procedures necessary in the circumstances; rather, such an engagement involves a limited reporting objective. Materiality is not a factor nor is whether the client is a nonissuer. The auditor is not required to disclaim an opinion on the other financial statements. For this type of engagement the auditor's report only refers to the statement audited. Reference in the 4th reporting standard to the financial statements *taken as a whole* applies equally to a complete set of financial statements and to an individual financial statement for one or more periods presented. (Chapter 28-IV-A; 9928; CSO: I.B.5.)

29. (b) Auditors generally perform analytical procedures that use data aggregated at a high level to assist in planning the nature, extent, and timing of other audit procedures. The objective is to identify such things as the existence of unusual transactions and events; and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications. They are not used to develop an auditor's preliminary judgment about materiality. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality is defined (in the context of an audit) as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement. Further, materiality judgments involve both quantitative and qualitative considerations. One could argue that an auditor does compare current and past financial results and financial positions to determine what is normal for an entity when setting materiality limits for the financial statements taken as a whole when planning the audit; however, the answer *they usually use financial and nonfinancial data aggregated at a high level* in the planning stage is the best answer to this question. Analytical procedures are not used to replace tests of controls. Analytical procedures can be used as substantive tests to obtain audit evidence (which is not part of the planning stage) about particular assertions related to account balances or classes of transactions. Substantive analytical procedures often involve the comparison of expectations developed by the auditor (not assertions developed by management) to recorded amounts or ratios developed from recorded amounts to achieve an audit objective related to a particular assertion made by management. (Chapter 22-III-B; 9929; CSO: II.D.2)

30. (d) The population size has little effect on the sample size. To determine the number of items to be selected for a particular sample for a test of controls, the auditor should consider the tolerable rate of deviation from the controls being tested, the likely rate of deviations, and the allowable risk of assessing control risk too low. An auditor applies professional judgment to relate these factors in determining the appropriate sample size. As the tolerable deviation rate increases, the sample size can be decreased, not increased. (Chapter 26-I-F; 9930; CSO: III.B.6.)

31. (b) An inherent limitation to internal control is the fact that controls can be circumvented by management override. Other limitations inherent to internal control include human failures such a faulty decision making and simple errors or mistakes. Additionally, controls can be circumvented by the collusion of two or more people. A well-designed internal control system does not ensure the achievement of an entity's control objectives; it only provides the entity with reasonable, not absolute, assurance due to these inherent limitations. (Chapter 22-II-E; 9931; CSO: II.F.10.)

32. (d) An entity may request the accountant to compile financial statements that omit substantially all the disclosures required by an applicable financial reporting framework, including disclosures that might appear in the body of the financial statements. The accountant may compile such financial statements, provided that the omission of substantially all disclosures is not undertaken with the intention of misleading those who might reasonably be expected to use such financial statements. Distribution is not

restricted to internal use; however, the compilation report should include a paragraph, after the *accountant's responsibilities* paragraph, that states that management has elected to omit the disclosures; that if the disclosures were included, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows (or equivalent presentations for OCBOA statements); and that, accordingly, the statements are not designed for those who are not informed about such matters. Acknowledgement in the notes to the financial statements is not sufficient. Whether the omission would influence a creditor is not a consideration. (Chapter 31-I-B ;9932; CSO: V.C.1.)

33. (a) When assessing the internal auditors' objectivity, the auditor should obtain information about such factors as the organizational status of the internal auditor responsible for the internal audit function, including whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors; whether the internal auditor has direct access and reports regularly to those charged with governance; and whether those charged with governance oversee employment decisions related to the internal auditor. The auditor should also obtain information about the client's policies *prohibiting internal auditors from auditing areas* where relatives are employed in important or audit-sensitive positions and *where internal auditors were recently assigned* or are scheduled to be assigned on completion of responsibilities in the internal audit function. Reviewing the internal auditor's reports to determine that their conclusions are consistent with the work performed is not done to assess objectivity; it is done to evaluate the effectiveness of their work. The auditor would not verify that the internal auditor's assessment of control risk was comparable to that of the auditor—the auditor has the ultimate responsibility to express an opinion on the financial statements; thus, judgments about assessments of inherent and control risks, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the auditor. The evaluation of the quality of the internal auditors' working paper documentation and their recent audit recommendations is not done to assess their objectivity; it is done to assess their competence. (Chapter 24-II-B; 9933; CSO: I.E.3.)

34. (a) In performing the audit, the auditor may request direct assistance from the internal auditors. This direct assistance relates to work the auditor specifically requests the internal auditors to perform to complete some aspect of the auditor's work. For example, *internal auditors may assist the auditor in* obtaining an understanding of internal control or *in performing tests of controls or substantive tests*. (Chapter 24-II-C; 9934; CSO: I.E.3.)

35. (c) Contingent liabilities arise from events or circumstances occurring before the balance sheet date, the resolution of which is contingent upon a future event or circumstance. Examples include pending or threatened litigation; actual or possible claims and assessments; obligations related to product defects; obligations related to product warranties; and obligations related to product coupons and premiums. The primary concern of an auditor regarding contingent liabilities is discovering their existence. The minutes would be likely to have information about the events or circumstances (lawsuits) that give rise to them. Outstanding purchase orders generally relate to accounts payable for normal operations, not contingent liabilities. Analytical procedures would not be nearly as likely (as effective) a procedure as reading the minutes. Tests of controls regarding cash disbursements would not be a likely procedure because this is appropriately an unpaid liability. (Chapter 28-VII-B; 9935; CSO: III.B.16.)

36. (b) In evaluating the entity's plans for dealing with the adverse effects of future events, the auditor would most likely consider the entity's plans to postpone expenditures to upgrade its IT system as a mitigating factor for a going concern problem. Regarding management's plans, the auditor should consider whether it is likely the adverse effect will be mitigated for a reasonable period of time and that such plans can be effectively implemented. The purchase of production facilities currently being leased are not as likely as the postponement of a major expense (upgrade of the IT system) to provide lower expenditures—the near future impact of a purchase instead of lease decision could be the same or higher expenditures. Payment of cash dividends that are in arrears would intensify, not mitigate cash flow problems. The increase of the useful lives of plant assets for depreciation purposes if justifiable could increase tax payments. Even if one infers this also means that the purchase of new assets would be

postponed this is not clearly stated as was the better answer, postponement of expenditures for the upgrade to the IT system. (Chapter 28-IX-D; 9936; CSO: IV.G.0)

37. (d) The auditor's conclusion about the entity's ability to continue as a going concern should be expressed (in an explanatory paragraph following the opinion paragraph) through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" or similar wording that includes the terms *substantial doubt* and *going concern*. Neither of the question's phrases contains these terms and both use language that is not as strong. Additionally, the auditor should not use conditional language in expressing a conclusion, such as: "If the Company continues to suffer recurring losses from operations and continues to have a net capital deficiency, there may be substantial doubt about its ability to continue as a going concern" or "The Company has been unable to renegotiate its expiring credit agreements. Unless the Company is able to obtain financial support, there is substantial doubt about its ability to continue as a going concern." (Chapter 28-IX-E; 9937; CSO: IV.J.1.)

38. (c) When the subsequently discovered information is found both to be reliable and to have existed at the date of the auditor's report, the auditor should first determine if there are persons currently relying or likely to rely on the financial statements who would attach importance to the information. The auditor would only notify each member of the board of directors that the auditor's report may no longer be associated with the financial statements or regulatory agencies that the auditor's report should no longer be relied upon if the client does not take action to make the appropriate disclosures. The client, not the auditor, would issue revised financial statements. (The disclosure by the client to users would include the revised statements and audit report. The reasons for the revision would ordinarily be described in a note to the financial statements and referred to in the auditor's report.) (Chapter 28-VII-C; 9938; CSO: IV.J.13.)

39. (b) If inventories are in the hands of public warehouses or other outside custodians*, the auditor ordinarily would obtain direct confirmation in writing from the custodian*. If such inventories represent a significant proportion of current or total assets (which this question did not indicate was the case), to obtain reasonable assurance with respect to their existence, the auditor should apply one or more of the following procedures as the auditor considers necessary in the circumstances: (1) test the owner's procedures for investigating the warehouse and evaluating the warehouse's performance; (2) obtain an independent accountant's report on the warehouse's control procedures relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouse is reliable; (3) observe physical counts of the goods, if practicable and reasonable; and/or (4) if warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate). (Chapter 25-III-C; 9939; CSO: III.B.8.)

40. (a) Audit reports, audit reviews, and audit procedures all require a level of independence that would necessitate that they be done by an independent accountant outside of the organization. However, compilation reports do not require that high level of independence and could be prepared by a board member without violating independence rules. (Chapter 32-I-C; 9940; CSO: VI.A.1.)

41. (d) According to the AICPA Code of Professional Conduct, any direct financial interest in a client corporation would impair a CPA’s independence even if it is immaterial. (Chapter 32-I-C; 9941; CSO: VI.A.1.)

42. (a) The analytical procedure most likely to be used during the planning stage of the audit is comparing current-year to prior-year sales volumes. Comparing the current-year ratio of aggregate salaries paid to the number of employees to the prior-year's ratio is the next best answer. Analytical procedures used in planning the audit generally use data aggregated at a high level which is true of both of these answers. However, in planning the audit, the auditor should also 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. The other two answer alternatives do not describe analytical procedures. (Chapter 22-IV-B; 9942; CSO: II.D.2.)

43. (c) Assessed risks and the basis for those assessments should be documented whether or not control risk is assessed at the maximum level. (**Editor note:** This question may be based on superseded guidance.) There is a direct relationship between control risk and substantive testing, thus if control risk is high the auditor should perform more, not fewer, substantive tests of details. If the auditor assesses control risk at the maximum level there is no point in performing more tests of controls. Documenting a control structure more extensively because it is not functioning well is nonsensical. (Chapter 23-II-E; 9943; CSO: II.H.3.)

44. (a) Internal auditors may assist the auditor in obtaining an understanding of internal control or in *performing tests of controls* or substantive tests which include both analytical procedures and tests of details. When direct assistance is provided, the auditor should assess the internal auditors' competence and objectivity and supervise, review, evaluate, and test the work performed by internal auditors to the extent appropriate in the circumstances. An auditor should not allow an internal auditor to be responsible for the audit of a major subsidiary of the company. The responsibility to report on the financial statements rests solely with the auditor. Unlike the situation in which the auditor uses the work of other independent auditors, this responsibility cannot be shared with the internal auditors. Independence is, of course, not possible for an internal auditor, but they are expected to be objective. (Chapter 24-II-C.;9944; CSO: I.E.3.)

45. (b) *The risk of incorrect acceptance* is the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated. *The risk of incorrect rejection* is the risk that the sample supports the conclusion that the recorded account balance is materially misstated when it is not materially misstated. These are sampling risks related to substantive tests of details. *The risk of assessing control risk too low* is the risk that the assessed level of control risk based on the sample is less than the true operating effectiveness of the control. *The risk of assessing control risk too high* is the risk that the assessed level of control risk based on the sample is greater than the true operating effectiveness of the control. (Chapter 26-I-D; 9945; CSO: III.B.6.)

46. (d) According to the AICPA Code of Professional Conduct, client records are the property of the client and cannot be retained by a CPA when the client demands their return. This is specifically identified as an act discreditable to the profession. (Chapter 32-IV-A; 9946; CSO: VI.A.1.)

47. (d) An interim review that requires knowledge of the entity's internal control is performed either for an issuer or a nonissuer per the exception when conditions exist such that the interim review is considered to be an extension of the annual audit. To update the CPA's knowledge about the entity's business and internal control, the CPA should consider the results of audit procedures performed with respect to the current-year's financial statements. Performing analytical procedures on selected accounts by comparing the interim amounts to other interim periods (rather than to the previous audited fiscal year-end) would more likely be a review procedure used to gather review evidence rather than to update the CPA's knowledge about the entity's business and internal control. Inquiry of the entity's legal counsel is generally not a review procedure nor is the testing of revenue transactions—these are audit procedures. Reviews do not contemplate the obtainment of corroborating evidence or tests of accounting records. Reviews consist principally of performing analytical procedures and making inquiries of persons within the entity responsible for financial and accounting matters. (Chapter 30-V-B; 9947; CSO: V.B.1.)

48. (b) A CPA does not have to be independent to perform a compilation engagement, but a separate paragraph should be added to the report that discloses the lack of independence. Additionally, the CPA may include the reasons for the lack of independence in the same paragraph. The disclosure of the reason(s) is not required, but if the CPA elects to do so, all the reasons must be included. (Chapter 31-IV-B; 9948; CSO: V.C.1)

49. (d) Reviews consist principally of performing analytical procedures and making inquiries of persons within the entity responsible for financial and accounting matters. Reviews do not contemplate the obtainment of corroborating evidence. The other answer alternatives describe procedures typically performed during a review engagement. (Chapter 31-I-C; 9949; CSO: V.A.1.)

50. (c) According to the AICPA Code of Professional Conduct, a CPA's independence is considered impaired if the CPA has a financial interest in the audit client or has a financial interest in an entity that has the ability to exercise significant influence over the audit client. Having a relative who obtained an insurance policy from the issuer before it became an audit client or who was in an accounting role at the audit client and ended employment before the period under audit began would not be considered an impairment to independence. The auditor having an automobile loan at standard terms from the audit client that is collateralized by the automobile is not considered to have their independence impaired. (Chapter 32-VII-A; 9950; CSO: VI.A.3.)

Solution 3-1 SIMULATION ANSWER: Accounts Receivable (AR) Confirmations

Customer	Action Required
A. Chip Technology	1. Exception noted; propose adjustment and request that the controller post it to the accounting records.
B. BiCon Semiconductor	4. Verify by examining shipping documents and subsequent cash collections.
C. Whistler's Computer Warehouse	1. Exception noted; propose adjustment and request that the controller post it to the accounting records.
D. Digital Digits	5. Verify that additional invoices noted on confirmation pertain to the subsequent year.
E. Rockford's	6. Not an exception, no further audit work deemed necessary.
F. Jungle Applications	4. Verify by examining shipping documents and subsequent cash collections.

(9832)

A. 1

The client should adjust the accounting records to reflect the receipt of the payment during year 2.

B. 4

The auditor should perform the additional audit procedures described, i.e., examining shipping documents and subsequent cash receipts to confirm the accounting records are correct.

C. 1

The client should adjust the accounting records to reflect the return of the materials.

D. 5

The auditor should perform the additional audit procedures described, i.e., examining the invoices noted on the confirmation to confirm they pertain to the subsequent year and thus, the accounting records are correct.

E. 6

There is no exception so no action is required.

F. 4

The auditor should perform the additional audit procedures described, i.e., examining shipping documents and subsequent cash receipts to confirm the accounting records are correct.

Solution 3-2 SIMULATION ANSWER: Audit Test and Purpose

a **Description of Procedure**	b **Audit Procedure Performed**	c **Classification of Audit Procedure**
A. Examined sales invoices to see if they were initialed by the credit manager indicating credit approval.	5. Inspection	2. Test of controls
B. Compared this year's expenses with last year's expenses and investigated unusual fluctuations.	1. Analytical procedures	1. Substantive procedures
C. Requested responses directly from customers.	2. Confirmation	1. Substantive procedures
D. Questioned management about subsequent events.	4. Inquiry	1. Substantive procedures
E. Observed the accounting clerk record the daily deposit of cash receipts.	7. Observation	2. Test of controls
F. Examined invoices to support additions to the fixed asset account during the year.	5. Inspection	1. Substantive procedures
G. Agreed sales invoices to credit files to determine whether the customer had a credit file and had been approved for credit.	9. Reperformance	2. Test of controls
H. Asked the accounting manager how often cash is deposited and by whom.	4 Inquiry	2. Test of controls

(9833)

A. Inspection; test of controls

Inspection consists of examining records or documents, whether internal or external, in paper form, electronic form or other media. In this case, the auditor inspected the sales invoices for evidence of authorization by the credit manager. Approval of sales by the credit manager is a control to prevent credit sales to customers who have not been approved for credit. This procedure tested that control.

B. Analytical procedure, substantive procedures

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. They range from simple comparisons, like this example, to the use of complex models. The comparison of expenses between years and the investigation of unusual fluctuations was used as a substantive procedure performed to detect material misstatements in expenses for the assertions of completeness and accuracy.

C. Confirmation; substantive procedures

Confirmation, which is a specific type of inquiry, is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions. It was used as a substantive test of details of the assertions of completeness, existence, and accuracy of the customers' accounts.

D. Inquiry; substantive procedures

Inquiry consists of seeking information of knowledgeable persons, both financial and nonfinancial, inside or outside of the entity. Inquiries can be formal written inquiries or informal oral inquiries. The auditor should consider the reasonableness and consistency of the responses in light of the results of other procedures and the auditor's knowledge of the entity and its industry—evaluating responses to inquiries is an integral part of the inquiry process. Inquiry by itself does not provide sufficient appropriate audit evidence to detect misstatements or to test the operating effectiveness of controls; thus, auditors complement inquiries with other procedures to corroborate the responses received. This inquiry was used as a substance procedure to test the assertion of the completeness of disclosures regarding type two subsequent events and other assertions, depending on the nature of the event, regarding type one events.

E. Observation; test of controls

Observation consists of looking at a process or procedure being performed by others. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed. Depositing cash receipts on a daily basis is a control. This procedure tested that control.

F. Inspection; substantive procedures

Inspection consists of examining records or documents, whether internal or external, in paper form, electronic form or other media. In this case, the auditor inspected the invoices to see if they provided evidence for the additions to the fixed asset account.

G. Reperformance; test of controls

Reperformance is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, either manually or through the use of computer-assisted audit techniques (CAAT). Investigating a customer's credit worthiness and approving a credit sale by reference to the customer's resulting credit file is a control to prevent credit sales to customers who have not been approved for credit. This procedure tested that control.

H. Inquiry; Test of controls

Inquiry consists of seeking information of knowledgeable persons, both financial and nonfinancial, inside or outside of the entity. Inquiries can be formal written inquiries or informal oral inquiries. The auditor should consider the reasonableness and consistency of the responses in light of the results of other procedures and the auditor's knowledge of the entity and its industry—evaluating responses to inquiries is an integral part of the inquiry process. Inquiry by itself does not provide sufficient appropriate audit evidence to detect misstatements or to test the operating effectiveness of controls; thus, auditors complement inquiries with other procedures to corroborate the responses received. This inquiry was used as a test of the controls over the deposit of cash receipts.

Solution 3-3 SIMULATION ANSWER: Research

AU	§	316	23	(9834)

.23 For entities that have an internal audit function, the auditor also should inquire of appropriate internal audit personnel about their views about the risks of fraud, whether they have performed any procedures to identify or detect fraud during the year, whether management has satisfactorily responded to any findings resulting from these procedures, and whether the internal auditors have knowledge of any fraud or suspected fraud.