2017 AUD Book Update

Page numbers refer to 2017 AUD textbook pages. When new/edited text is shown along with old text, the new/edited text is highlighted in gray, unless noted otherwise. For those who prefer to purchase a new textbook due to the significant amount of changes, please visit https://www.rogercpareview.com/cpa-courses/textbooks.

Page 4-16

**Activity** – Measures how effectively the company uses its assets

| 5. Receivables turnover | Net credit sales | Average trade receivables (net) | Measures liquidity of receivables |
• **Allocation and valuation**
  
  o The auditor may determine that the entity's procedures for measuring and recording inventory reasonably assure that inventory is fairly measured and valued in accordance with GAAP, in which case the auditor will perform tests of controls to make certain that procedures are being followed as designed.

  o The auditor may obtain evidence that inventory is appropriately reported at the lower of cost or net realizable value by performing tests involving recalculation to determine if the client has made appropriate calculations.

  o The auditor may perform substantive analytical procedures to obtain satisfaction that inventory is fairly stated by comparing amounts reported as inventory and cost of sales, as well as the relationships to sales and accounts payable to expectations.
Applying the U-PERCV approach:

- **Understandability & Classification** – To verify that transactions and events have been recorded in the proper accounts and are clearly described, the auditor would read the financial statements and trace purchases into the purchases journal.
- **Presentation & Disclosure** – To verify that all necessary disclosures have been made and that inventory is classified properly, the auditor will read the financial statements and notes.
- **Existence or Occurrence** – To verify that the inventory exists, the auditor will observe the physical count of inventory.
- **Rights and obligations** – To verify that the client owns the inventory, the auditor will examine vendor invoices.
- **Completeness & Cutoff** – To verify that the client has included all inventory owned by them at year-end, the auditor will perform cutoff tests of receiving and shipping occurring in the days surrounding the balance sheet date.
- **Valuation, Allocation & Accuracy** – To verify that the client is properly accounting for the inventory at the lower of cost or net realizable value, the auditor will review supplier catalogs in order to estimate the replacement cost of the inventory on hand.
Kiting is a special type of fraud used by management to overstate cash and cash equivalents at the end of the period. It is accomplished by making transfers from one of the entity's accounts to another, recording the increase in the recipient account at the end of the current fiscal period and recognizing the decrease in the disbursing account at the beginning of the subsequent period. Provided the checks did not clear the disbursing account before the year-end, the disbursements would simply not be recorded and, as a result, would not be a reconciling item. The deposits to the recipient accounts, however, will be reported as deposits in transit that will be shown as clearing the account shortly after year-end on the cutoff statement.

One common way in which kiting can be detected is when the auditor prepares a schedule of intercompany bank transfers. Using such a schedule, the auditor can verify that the reduction in the disbursing account is recorded in the same period as the increase in the recipient account.
### Marketable Debt Securities

<table>
<thead>
<tr>
<th>Trading securities (HFT)</th>
<th>Available for sale (AFS)</th>
<th>Held to maturity</th>
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<tbody>
<tr>
<td><strong>Balance Sheet:</strong></td>
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<tr>
<td>Current only</td>
<td>Current/non-current</td>
<td>Non-current</td>
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<td>Debt only</td>
<td>Debt only</td>
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<tr>
<td>FMV</td>
<td>FMV</td>
<td>Amortized cost</td>
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<tr>
<td><em><em>Cum <em>Unrealized gains/losses</em></em> in equity as accumulated other comprehensive income</em>*</td>
<td></td>
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</table>

### Stmt of Comprehensive Income:

**INCOME:**

- *Unrealized gains/losses
  - Realized gain/loss
  - Interest income
  - Realized gain/loss
  - Interest income
  - Non-temporary decline in value
  - Non-temporary decline in value

**OTHER COMP INCOME:**

- (OCI)
  - Unrealized gains/losses

### Cash Flows:

- Operating activity
- Investing activity
- Investing Activity
Proving **Allocation and valuation** requires several different procedures:

- Vendor invoices are examined to determine that correct prices have been recorded for inventory purchases.
- For manufactured inventory, an examination of standard cost rates (especially for overhead that is applied to inventory costs) is necessary.
- **Inventory turnover rates** should be examined to identify slow-moving and obsolete inventory that may need to be written off or written down to **net realizable value**.
- Inquiries should be made of production supervisors and inventory control personnel about slow-moving or obsolete inventory as well.
- **Current vendor invoices can be examined to evaluate replacement cost for lower of cost or market valuations.**
- The auditor can recalculate the net realizable value for performing a lower of cost or market evaluation.
Existence
The amount reported as fixed assets are actual assets in the custody of the entity. A misrepresentation in relation to existence might be the inclusion on the balance sheet of fixed assets that have been sold, capitalizing an expenditure that should have been recognized as an expense, or recording an acquisition that did not occur or was not on behalf of the entity.

• Observe fixed assets
Substantive procedures the auditor may perform in relation to existence may include:

- **Observation** – The auditor may physically observe fixed assets to ascertain their existence;
- **Confirmation** – The auditor may obtain confirmations directly from warehousemen who may be holding inventory or fixed assets for the entity;
- **Inspection** – The auditor may inspect purchase documents for items purchased during the period;
- **Inspection** – The auditor may inspect insurance policies and property tax bills to make certain that reported fixed assets are listed when appropriate;
- **Inspection** – The auditor may review agreements between the entity and other parties or regulators granting the entity rights associated with identifiable intangible assets; and
- **Inspection** – The auditor may trace cash receipts that are from sources other than revenues to verify that all sales of fixed assets have been properly recorded.
Though there is little likelihood of notes and bonds payable going unrecorded, proper classification on the balance sheet is an important issue in connection with the assertion of disclosure and presentation. In particular, if a current note is renewed shortly after year-end, the auditor needs to ensure that the note is classified as a long-term debt rather than a current one.

**Going Concern**

Although not required in some special purpose financial reporting frameworks, when financial statements are prepared in accordance with GAAP, Topic ASC 205, Subtopic 40, requires management to evaluate whether the entity has the ability to continue as a going concern for a reasonable time. The ability to continue as a going concern implies that the entity will be able to meet its obligations as they come due. A reasonable period of time is considered one year from the date on which the financial statements are issued, or, when appropriate, one year from the date on which they are available to be issued.

Even when the applicable financial reporting framework does not require management to perform such an evaluation, if characteristics of the financial reporting framework according to which the financial statements are being prepared incorporates a going concern assumption, the preparation of the financial statements requires management to assess the entity's ability to continue as a going concern. The existence of receivables that are not written down to amounts received, payments for assets that are capitalized and amortized instead of being expensed when incurred, and other similar accounts that have long-term implications, indicate that the framework in use does incorporate such an assumption.

Unless financial statements are prepared in accordance with the cash basis or a comparable basis, they are likely being prepared in accordance with a going concern assumption. As a result, preparing the financial statements requires management to assess the entity's ability to continue as a going concern even when the applicable financial reporting framework does not explicitly require it.

During the performance of the risk assessment procedures applied by the auditor in obtaining an understanding of the entity and its environment, including its internal control, the auditor should determine if management has made a preliminary evaluation of whether events or conditions exist that raise doubts.

- If management has performed such an evaluation, the auditor should discuss it with management and, if management has identified events or conditions that raise substantial doubt, the auditor should understand management's plans to address them.
- If management has not performed such an evaluation, the auditor should inquire of management whether such events or conditions exist.

The auditor's evaluation should address management's evaluation, covering the same period of time, and should consider whether management has evaluated all events and conditions of which the auditor is aware.

When events or conditions have been identified, the auditor is required to obtain sufficient appropriate audit evidence as to whether they, when considered in the aggregate, raise a
substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, as well as any mitigating factors. The auditor's procedures will include:

- Requesting management to make an evaluation if one has not already been made;
- Evaluating management's plans in relation to the events and conditions to determine if it is probable that they can be implemented effectively and would mitigate the events and conditions that raise the doubt;
- Evaluating a cash flow forecast and analysis, if one was prepared by management, including the reliability of the underlying data and determining if there is adequate support for assumptions made; and
- Considering whether additional facts or information has become available based on which management made its evaluation.

If, before considering management's plans, the auditor believes that substantial doubt exists as to the entity's ability to continue as a going concern, the auditor should request written representations from management. They should:

- Describe management's plans intended to mitigate the adverse effects of events or conditions contributing to the substantial doubt, including the probability that they can be implemented effectively; and
- Indicate that all relevant matters of which management is aware have been disclosed, including significant conditions and events, and also including management's plans.

Based on the results of the audit procedures applied, the auditor will conclude that either management's plans do, or do not, alleviate the adverse effects of events and conditions causing the substantial doubt as to the entity's ability to continue as a going concern. Based on that conclusion, the auditor will determine if disclosure is adequate.

- If management's plans are expected to mitigate the adverse effects, indicating that there is no longer substantial doubt as to the entity's ability to continue as a going concern, the disclosure should describe the events and conditions that created the doubt, management's evaluation of their significance, and management's plans that mitigated the adverse effects.
- If management's plans are not expected to mitigate the adverse claims to the extent that they remove the doubt, the disclosure will be similar, except it will also indicate that there is substantial doubt. In addition, it will refer to management's plans that are intended to mitigate the effects, rather than indicate that the effects have been mitigated.
Audits Performed in Accordance with GAAS as well as a Different Set of Standards

An auditor may be engaged to perform an audit in accordance with some set of standards, other than PCAOB standards, but in addition to auditing standards generally accepted in the United States of America (GAAS). The auditor may accept such an engagement, but would be required to perform the engagement in accordance with GAAS as well as the other set of standards.

- If the audit was conducted applying both sets of standards in their entirety, the audit report would indicate that the audit was conducted in accordance with GAAS and the other set of standards, naming the source of the standards.
- If, on the other hand, the second set of standards was not applied in its entirety, the report will indicate compliance with GAAS, excluding any mention of the other standards.

If the second set of standards is PCAOB standards, the content of the report will depend on whether the audit was within the jurisdiction of the PCAOB. If the audit is not within the jurisdiction of the PCAOB, the report will refer to the PCAOB standards in addition to GAAS. The report will follow the guidelines of one prepared in accordance with the PCAOB standards and indicate that it was also performed in accordance with GAAS.
Basis for Qualified Opinion (new paragraph before)
The Company has stated inventories at cost in the accompanying balance sheets. Accounting principles generally accepted in the United States of America require inventories to be stated at the lower of cost or net realizable value. If the Company stated inventories at the lower of cost or net realizable value, a write down of $XXX would have been required at December 31, 20X1. Accordingly, cost of sales would have been increased by $XXXX, and net income, income taxes, and stockholders' equity would have been reduced by $XXXX, $XXXX, and $XXXX as of and for the year ended December 31, 20X1.
Uncertainty – Going Concern Doubt (After)

Emphasis of Matter
The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note C to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubts about its ability to continue as a going concern. Management’s plans in regard to these matters are also described in Note C. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

Events or conditions may indicate that there could be substantial doubt as to whether the entity has the ability to continue as a going concern. If this is the case, the auditor will make inquiries of management and gather reliable audit evidence to support one of several possible conclusions:

1. If the auditor resolved that the events and conditions are not severe enough to warrant a going concern modification, the auditor will document the findings, but the audit report is not affected.
2. If the auditor concludes that there is a going concern issue, it is required to be disclosed in the footnotes to the financial statements, with one set of disclosures if management’s plans are expected to be adequate and another set of disclosures if they are not.
   - If disclosure is adequate, the auditor will issue a report with an unmodified opinion and the report will have an emphasis-of-matter paragraph drawing attention to the matter after the opinion in the auditor’s report.
   - If disclosure is not adequate, it represents a departure from the applicable financial reporting framework.
ASSOCIATION WITH FINANCIAL STATEMENTS

When a CPA is associated with a client's financial statements, there are numerous types of engagements that may be entered into. The nature of the engagement will determine which standards the CPA must be in compliance with. When associated with the financial statements of a **publicly-held entity**, the accountant will follow the requirements of the Public Company Accounting Oversight Board (PCAOB).

When the CPA is associated with the financial statements of a **nonpublic, nongovernmental entity**:

- The accountant may be engaged to audit financial statements, in which case the accountant will follow Generally Accepted Auditing Standards (GAAS) in the form of the clarified Statements on Auditing Standards (clarified SAS) issued by the Auditing Standards Board (ASB) of the AICPA.
- The accountant may be engaged to review the financial statements, in which case the accountant will follow Statements on Standards for Accounting and Review Services (SSARS) issued by the Accounting and Review Services Committee (ARSC) of the AICPA.
- The accountant may be engaged to compile the financial statements, in which case the accountant will also follow SSARS.
- The accountant may be engaged to prepare financial statements, in which case the accountant will also follow SSARS.
  - The accountant may be engaged to perform bookkeeping for a client, as a result of which financial statements may be prepared. The preparation of financial statements, under those circumstances, is part of the bookkeeping engagement, not a SSARS engagement.
  - In order for a financial statement preparation engagement to fall under SSARS, the client would specifically request that the accountant prepare the financial statements.

In a SSARS engagement to prepare financial statements, the client selects the applicable financial reporting framework but the accountant takes responsibility for the preparation and fair presentation of the financial statements, not the client.

Audits and reviews are considered **attest engagements**. An attest engagement is an engagement that requires independence as defined by the AICPA professional standards. Although not an attest engagement, a compilation also requires the accountant to be independent. As discussed below, however, it is not considered an attest engagement because SSARS allows the CPA to perform a compilation when not independent provided certain requirements are met.

Audits and reviews are also considered **assurance engagements**. An assurance engagement is an engagement in which the accountant is required to evaluate the **accuracy or completeness** of the
information provided by management or otherwise gather evidence that will serve as a basis for a report in which the accountant expresses an opinion, in an audit, or a conclusion, in a review, on the information. Although a compilation is not an assurance engagement, a report is issued. It does not contain, however, any expression of an opinion, a conclusion, or express any assurance.
• A presumptiontively mandatory requirement, associated with the word “should,” is also required to be complied with when relevant. In rare circumstances, however, the accountant may find it necessary to perform alternative procedures, such as when performance of the procedure presumptively required would likely be ineffective. In such cases, the accountant must document the reason for the departure and an indication of how the alternative procedures performed achieved the objectives of the presumptively mandatory requirement;
  o In addition to the specific relevant requirements of SSARS, the accountant should consider interpretive publications.
  o The fact that the accountant should consider interpretive publications establishes a presumptively mandatory requirement to consider the guidance in the publications, but does not to establish a requirement to apply it.
  o The accountant is, of course, not required to comply with guidelines in interpretive publications. They are nonauthoritative and, if the accountant intends to comply with their guidelines, the accountant should make certain that they do not contradict or reduce the effectiveness of actions taken to follow authoritative literature.

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Before accepting or continuing an engagement or a relationship with a client, the accountant should ascertain that:
• All ethical requirements will be satisfied;
• Reliable information needed to complete the engagement will be available;
• There is no reason to doubt the client's integrity;
• The financial reporting framework selected by management is acceptable; and
• Management has acknowledged responsibility for:
  o Selecting the financial reporting framework;
  o The design, implementation, and maintenance (DIM) of internal control relevant to financial reporting, although this would not be the case if the accountant decides to accept such responsibility, which could only occur if no assurance is being provided because accepting those responsibilities would be an example of an accountant assuming management responsibilities, which would impair the accountant's independence;
  o Preventing and detecting fraud;
  o Compliance with applicable laws and regulations;
  o The accuracy and completeness of information provided by management; and
  o Providing the accountant with access to all relevant information and to persons within the entity, as considered appropriate by the accountant.

Lecture 7.02

PREPARATION OF FINANCIAL STATEMENTS (AR-C 70)

An engagement to prepare financial statements is a nonattest/nonassurance engagement in which the accountant prepares financial statements in accordance with an applicable financial reporting framework on the basis of information provided by management. The accountant is not required to verify the accuracy or completeness of the information provided by management. In addition,
since a preparation is a nonattest engagement, the accountant is not required to evaluate independence.

These standards also apply when the accountant is engaged to prepare historical financial information other than financial statements. In such cases, the requirements are adapted, as appropriate.

When a CPA is engaged to compile, review, or audit a client’s financial statements or prospective financial statements, but the client has not prepared the financial statements and expects the CPA to do so, the CPA is actually involved in two related engagements:

- There is a nonattest engagement, which is a form of bookkeeping engagement, to prepare the financial statements.
  - This engagement is not subject to SSARS.
  - While, on separate occasions, the accountant may be asked to perform two separate engagements in relation to the same financial statements, such as reviewed financial statements prepared for the client's banker, and audited financial statements requested later as a result of a contract being entered into, the accountant would not have two SSARS engagements in relation to a single set of financial statements performed simultaneously.
  - The accountant is required to determine if independence is impaired under the AICPA Code of Professional Conduct.

- There is a compilation or review engagement, which are also engagements subject to the requirements of SSARS.
  - If independence is not impaired, the accountant may perform either a review or a compilation.
  - If independence is impaired, the accountant may not perform a review and may only perform a compilation if certain requirements are adhered to.

When a CPA is engaged to prepare financial statements that will not be compiled, reviewed, or audited, or, if they will be but that engagement will be performed by another CPA, the preparation engagement is a nonattest engagement that is subject to SSARS.

- Since the engagement is not an attest engagement, nor will the accountant be performing an attest engagement, there is no requirement to evaluate independence.
- If, however, the accountant expects to perform services for the client that will require independence, such as when the CPA prepares quarterly financial statements but reviews or audits the annual statement, the accountant will wish to make certain that the independence related requirements of the Code are complied with.

In certain circumstances, an accountant may be engaged to prepare historical financial statements, other historical financial information, or prospective financial information in an engagement that is not required to be performed in accordance with SSARS. These other nonattest engagements include:

- Information that is solely for submission to a taxing authority;
- Information to be included in a written personal financial plan prepared by the accountant;
- Information to be used in conjunction with litigation services that involve pending or potential legal or regulatory proceedings; or
- Information prepared in conjunction with business valuation services.
The accountant may prepare financial statements that **omit substantially all disclosures** required by the applicable financial reporting framework, provided the omission was not for the purpose of misleading users. The omission should, however, be disclosed in the financial statements.

As indicated, the accountant is not required to verify the accuracy or the completeness of the information from which the financial statements are prepared and, as a result, is neither expected to, nor responsible for, the detection of material misstatements, whether due to error or fraud. The accountant may not, however, ignore information about which the accountant is aware. If, due to knowledge obtained by the accountant in another engagement for the same client, in an engagement for another client in the same industry, the accountant's knowledge of the industry, or some other source, the accountant becomes aware of a potential material misstatement to the financial statements, the accountant should take some action. An accountant should never knowingly be associated with materially misstated financial statements unless the accountant is satisfied that the misstatement has been adequately disclosed to the financial statement users.

In such circumstances, the accountant should request that the client:
- Can demonstrate why the information is correct and should be accepted by the accountant;
- Corrects the information; or
- Finds an effective way to communicate the misstatement to users of the financial statements so that they will not be lead to inappropriate conclusions.

**Documentation in a Preparation Engagement**

The accountant’s documentation for a preparation engagement is required to include:
- The engagement letter; and
- A copy of the financial statements.

**Preparing Prospective Financial Information**

The preparation of prospective financial information requires management to make various significant assumptions about what will occur in the future, including the state of the economy, the industry in which the entity operates, the regulatory environment, and numerous other items. Because an understanding of these assumptions is essential to a user’s understanding of the prospective financial information, the accountant should not prepare prospective financial information that does not include a summary of significant assumptions.

A financial projection is a unique type of prospective financial information in that it illustrates what management believes will result from the occurrence or nonoccurrence of a future transaction or event. As a result, the accountant should not accept an engagement to prepare a financial projection that does not include both:
- Identification of the hypothetical assumptions upon which the projection is based; and
- A description of the limitations on the usefulness of the presentation.
### Lecture 7.04

**3 SSARS ENGAGEMENTS** (Nonissuer/Nonpublic) (all must adhere to *General Principles for Engagements Performed in Accordance with SSARS AR-C 60*)

<table>
<thead>
<tr>
<th>Preparation of F/S (AR-C 70)</th>
<th>Compilation (AR-C 80)</th>
<th>Review (ICORRIIA) (AR-C 90)</th>
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<tbody>
<tr>
<td><strong>Signed Engagement Letter</strong></td>
<td><strong>Signed Engagement Letter</strong></td>
<td><strong>Signed Engagement Letter</strong></td>
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<td>Both Client &amp; Acct</td>
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<td>Mgt resp letter - Required</td>
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**OBJ:** *Prepare F/S in accord w applicable Fin Reporting Framework (F/W)*

- Apply accounting and financial reporting expertise to assist management in the presentation of financial statements and report in accordance with AR-C 80 w/o giving any assurance / no mat modif made to be accord w applic fin rept F/W.

- *Obtain limited assurance* as a basis for reporting whether the accountent is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework, primarily through the performance of *inquiry and analytical procedures.*

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<td><em>Read the F/S - free of obvious material misstatements and appropriate in form?</em></td>
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- Not required to evaluate independence

- Not independent, add sentence (if title used, do not include word: Independent)

- MUST be independent

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<thead>
<tr>
<th>NonAttest engagement</th>
<th>NonAttest engagement</th>
<th>Attest engagement</th>
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<tr>
<td>- NO assurance</td>
<td>- NO assurance</td>
<td>- Obtain Limited Assurance</td>
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- Express NO opinion or conclusion

- Express a conclusion providing limited assurance but express NO opinion

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<td>- <em>Indicate and explain non-GAAP or Inadeq disclosure</em></td>
<td>- <em>Expected form &amp; content of compilation report</em></td>
<td>- <em>Expected form &amp; content of review report</em></td>
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<tr>
<td>- Mgt agrees, each page “No assurance is provided”</td>
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<th>SSARS, by ARSC of AICPA</th>
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<th>SSARS, by ARSC of AICPA</th>
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<tr>
<td>- <strong>Report Required:</strong> - 1 ¶</td>
<td>- Mgt Resp, SSARS, did NOT audit/Rev, no procedures performed to verify accuracy or completeness but no opinion, conclusion or assurance</td>
<td>- <strong>Report Required:</strong> - 4 ¶s → 4th ¶ is limited assurance:</td>
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<td>- <em>Intro</em> – reviewed F/S, Analy &amp; Inq, less in scope</td>
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<td>- <em>Mgt Resp</em> - prep &amp; fair present of F/S design, implement, maintain (dim) I/C</td>
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<td>- <em>Acct’s Resp</em> – SSARS, ARSC of AICPA</td>
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<td>- perform proc to provide Lim assur, mat modif…. Reas basis for conclusion</td>
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<td>- <em>Acct’s conclusion</em> – Lim Assur</td>
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- **No report, each page of F/S, “No Assurance is Provided”**

©Roger CPA Review
Preparation of F/S (AR-C 70) | Compilation (AR-C 80) | Review (ICORRIIA) (AR-C 90)
---|---|---
If client refuses 'no assurance is provided' within F/S  
- Issue disclaimer,  
- Upgrade to compilation (client must agree); or  
- Withdraw from the engagement. | If need to modify, add Additional Explanatory Paragraph:  
- Comparative Reports (PY Reviewed, this year compiled)  
- Special Purpose Framework (OCBOA) (lim use if regulatory or contractual basis)  
- Lack of independence (may include reasons)  
- *Inadequate Disclosure  
  *A Limited Use ¶ = “Not designed for those who are not informed about such matters”  
- Departures from applicable fin rept framework (Non-GAAP)  
- Supplementary info included in rept  
- Additional Explanatory Paragraph – (Going Concern doubt, material subsequent event, change in principle/estimate) | Add a 5th ¶ if modify with Emphasis or Other Matter Paragraph:  
- Comparative Reports (PY Reviewed, this year compiled)  
- Special Purpose Framework (OCBOA) (lim use if regulatory or contractual basis)  
- *Inadequate Disclosure  
  *A Limited Use ¶ = “Not designed for those who are not informed about such matters”  
- Departures from applicable fin rept framework (Non-GAAP)  
- Supplementary info included in rept  
- Emphasize a matter – (Going Concern doubt, material subsequent event, change in principle/estimate) |

Lecture 7.05

COMPILATION ENGAGEMENTS (AR-C 80)

AR-C section 80 indicates that “the objective of the accountant in a compilation engagement is to apply accounting and financial reporting expertise to assist management in the presentation of financial statements and report in accordance with this section 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 them to be in accordance with the applicable financial reporting framework.”

A CPA may also be engaged to compile other historical financial information, pro forma financial information (AR-C 120), or prospective financial information. **Pro forma** financial information is historical financial information adjusted to reflect what management believes would have happened in that period if an event or circumstance had or had not occurred. It may, for example, show what management believes its prior period's results would have been if they had purchased a particular machine or if they had not lost a major customer to a competitor.

A CPA may also compile prospective financial information (AR-C 80). One basic type of prospective financial information is the financial **forecast**, which reports what management believes (expects) its future results of operations and financial position will be based on management's assumptions as to the conditions under which the entity will be operating in the future. These assumptions may relate to the economy, the industry in which the entity operates, the availability of human and physical resources, and a variety of other factors.
The other basic type of prospective financial information is a financial projection, which incorporates the same assumptions as applicable to a financial forecast but also considers a hypothetical assumption related to the occurrence or nonoccurrence of some significant event or transaction.

- All prospective financial statements should include a summary of significant assumptions. In addition, financial projections should include an indication of the hypothetical assumption upon which it is based and an indication of the limitations on the usefulness of such a presentation.

Requirements in a Compilation Engagement

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Under certain circumstances, the accountant is required to withdraw from the engagement, informing management of the reasons. This will be the case if:

- Management is unable or unwilling to provide information the accountant considers necessary in order to satisfactorily complete the engagement; or
- The financial statements contain departures from the applicable financial reporting framework and management will not make proposed changes or disclose the departures, although the accountant would not be required to withdraw if disclosure of the departures in the compilation report would sufficiently inform users.
Notice that there are four elements in the report (CARD):

- **Compiled** - The compiled statements are identified.
- **AICPA standards** - The reference to SSARS distinguishes the accountant's work from similar work that might be performed by a non-CPA. This wasn't needed in an audit (since non-CPAs are legally prohibited from performing audits), but non-CPAs are capable of simply presenting statements, so the distinction of work conforming to AICPA standards (which require that a CPA perform the engagement) is added to enhance the perceived value.
- **Responsibility of management** - We emphasize that these are the financial statements of management, they are not the accountant's.
- **Do not express an opinion or provide assurance** - We explicitly state that we didn't audit or review and do not express an opinion or provide assurance, so that the user of the statements will not misunderstand our involvement.
INDEPENDENT ACCOUNTANT’S COMPILATION REPORT
(Omitted Disclosures)

Board of Directors and Stockholders
X Company

Management is responsible for the accompanying financial statements of XYZ Partnership, which comprise the statements of assets, liabilities, and partners’ capital—tax-basis as of December 31, 20X2 and 20X1 and the related statements of revenue and expenses—tax-basis, and changes in partners’ capital—tax-basis for the years then ended in accordance with the tax-basis of accounting, and for determining that the tax-basis of accounting is an acceptable financial reporting framework. I (We) have performed compilation engagements in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

The financial statements are prepared in accordance with the tax-basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

Management has elected to omit substantially all the disclosures ordinarily included in financial statements prepared in accordance with the tax-basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s assets, liabilities, equity, revenue, and expenses. Accordingly, the financial statements are not designed for those who are not informed about such matters.

Accountant’s signature
Accountant’s city and state
Date

The accountant may compile financial statements that omit substantially all disclosures required by the applicable financial reporting framework. The accountant’s compilation report will be modified by adding a separate paragraph indicating that:

- Management has elected to omit substantially all disclosures required by the applicable financial reporting framework.
- The information, had it not been omitted, may influence conclusions about the entity’s performance or financial position.
- The financial statements are designed exclusively for those knowledgeable about such matters.
The accountant may not report on statements that omit disclosures if the omissions were intended to mislead the user. This might be the case, for example, if the client is trying to conceal a large potential loss due to a pending lawsuit from a potential lender.

When the accountant is not independent of the entity, the report will be modified to indicate the lack of independence.

- The indication will be in a separate final paragraph of the report.
- The accountant may, but is not required to, disclose the reasons for the lack of independence.
  - The description may be as brief or extensive as the accountant feels appropriate under the circumstances.
  - If disclosure is made, all reasons impairing independence must be disclosed.

If the accountant uses a title on the compilation report, it should not include the word independent.

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**ACCOUNTANT'S COMPILATION REPORT**  
(Lack of Independence – Reasons Not Disclosed)

Standard 1st paragraph:

We are not independent with respect to X Company.

---

**ACCOUNTANT'S COMPILATION REPORT**  
(Lack of Independence – Reasons Disclosed)

Standard 1st paragraph:

We are not independent with respect to X Company as during the year ended December 31, 20X2, a member of the engagement team had a material indirect financial interest in X Company.
The modification, in the form of a separate paragraph, will:

- Disclose the departure; and
- Either indicate the effect on the financial statements, if determined by management; or indicate that the effect has not been determined by management.

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**INDEPENDENT ACCOUNTANT'S COMPILATION REPORT**
*(Departure from the Applicable Financial Reporting Framework)*

**Standard 1st paragraph:**

*Accounting principles generally accepted in the United States of America require that investments in marketable securities classified as available for sale be stated at market value with unrealized gains and losses recognized in other comprehensive income, a component of stockholders' equity. Management has informed us that X Company has stated its investments in available for sale securities at cost and that if accounting principles generally accepted in the United States of America had been followed, the investment account and stockholders' equity account would have been decreased by $150,000.*

The accountant's compilation report may not be modified to indicate that the financial statements are not in conformity with the applicable financial reporting framework. If the accountant does not believe that disclosure adequately describes the deficiencies in financial reporting, the accountant should withdraw from the engagement and provide no further services in relation to those financial statements.

The accountant may be engaged to **compile comparative financial statements** in which the prior period financial statements had a GAAP departure that was subsequently remedied. When this is the case, the compilation report on the comparative financial statements will be the same as an unmodified report on comparative statements with the following other-matter paragraph added to the end:

**INDEPENDENT ACCOUNTANT'S COMPILATION REPORT**
*(Changing Reference from Prior Year)*

**Standard 1st paragraph:**

*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.*

When **supplementary information accompanies compiled financial statements**, the accountant will indicate that either the supplementary information was or was not compiled and if the accountant is reporting on the supplementary information.
When the applicable financial reporting framework under which the financial statements were prepared requires supplementary information, the accountant’s report will be modified to indicate:

- Whether the **required supplementary information** is included, partially included, or omitted
- Whether or not the required supplementary information that is included was compiled by the accountant and is being reported upon.

Although not covered under SSARS, the unaudited financial statements of a public company often involve work comparable to a compilation. Nonetheless, the report on unaudited financial statements of a public company must not say they were compiled, but merely state in a one-sentence report:

“The accompanying balance sheet of X Company as of December 31, 20X1, and the related statements of income and comprehensive income, retained earnings, and cash flows for the year then ended were *not audited by us* and, accordingly, we do not express an opinion on them.”

When reporting on prospective financial information, in addition to the requirements associated with a compilation report, the report will include:

- A statement that the forecasted or projected results may not be achieved; and
- A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

**Documentation in a Compilation Engagement**

The accountant’s documentation for a compilation engagement is required to include:

- The engagement letter;
- A copy of the financial statements and
- A copy of the accountant’s compilation report.

**Lecture 7.06**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.

**Lecture 7.07**

**REVIEW ENGAGEMENTS (AR-C 90)**

Section AR-C 90 of SSARS indicates that “the objective of the accountant when performing a review of financial statements is to **obtain limited assurance** as a basis for reporting whether the accountant is aware of any material modifications that should be made to the financial statements for them to be in accordance with the applicable financial reporting framework, primarily through the performance of **inquiry and analytical procedures**.”

In addition to historical financial statements, reviews may be performed in accordance with SSARS in relation to other historical financial information, but may not be performed in relation to pro
Reviews of pro forma financial information are performed in accordance with Statements on Standards for Attestation Engagements (SSAE). Note that the objective is to obtain limited assurance, not to provide limited assurance that the financial statements are not in need of material modification in order to be in accordance with the applicable financial reporting framework. The accountant’s review report is designed to provide the users with limited assurance regarding those financial statements. The accountant performs the review to obtain review evidence, providing comfort to the accountant who, in turn, provides limited assurance.
Supplementary Information Accompanying Reviewed Financial Statements

When supplementary information accompanies reviewed financial statements, the accountant will indicate the degree of responsibility the accountant is taking in relation to the supplementary information. This may be done in either an other-matter paragraph in the accountant's review report or a separate report on the supplementary information. The other-matter paragraph or separate report will state:

- The supplementary information is the representation of management and is derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements;
- That it is not a required part of the financial statements, but rather is provided for further analysis; and
- If the accountant has reviewed the supplementary information, that:
  - It has been reviewed, applying the review procedures applied in the accountant's review of the basic financial statements;
  - Whether the accountant is aware of any material modifications required in order for it to be in accordance with the applicable financial reporting framework; and
  - It has not been audited and, accordingly, no opinion is expressed.
- If the accountant has not reviewed the supplementary information that:
  - It has not been audited or reviewed; and
  - The accountant does not express an opinion, a conclusion, nor provide any assurance in relation to the supplementary information.
OTHER SSARS ISSUES

Compilation of Pro Forma Financial Information – AR-C Section 120

When SSARS 21 was issued, it replaced all of the existing standards for compilation and review engagements by re-writing them in the clarity format, with the exception of AR Section 120, Compilation of Pro Forma Financial Information. It was re-written applying clarity protocol with the issuance of SSARS 22, which was issued in September 2016 and became effective May 1, 2017, creating AR-C Section 120.

Pro forma financial information consists of historical financial information that is derived from historical financial statements of an entity, but modified to reflect what management believes the financial statements would have looked like if certain decisions had or had not been made, affecting the period being presented. These decisions may relate to a specific transaction or event such as a business combination, disposal of a business segment, making a significant capital expenditure, or a change in the form of business organization.

An accountant may assist a client in presenting pro forma financial information without issuing a compilation report. Such an engagement is a nonattest engagement and the accountant is subject to the applicable sections of the code of professional conduct, but there are currently no professional standards to be followed in its conduct. When an accountant is engaged to report on pro forma information, the accountant is required to comply with the applicable standards. As a result, when engaged to report on pro forma financial information, the accountant would perform a compilation in accordance with SSARS.

AR-C Section 120 specifies that the objective of the accountant in a compilation of pro forma financial information is to apply accounting and financial reporting expertise to assist management in the presentation of pro forma financial information and report in accordance with this section (AR-C Section 120) without undertaking to obtain or provide any assurance on the pro forma financial information.

As is true of other SSARS engagements, the accountant is required to apply AR-C Section 60, the General Principles for Engagements Performed in Accordance with SSARS. In addition, as is true for any compilation engagement, the accountant is required to determine whether independence has been impaired. If it has been, the accountant may still accept the engagement but the compilation report will be required to indicate the lack of independence.

Acceptance and Continuance of the Engagement and the Client Relationship

As a prerequisite to acceptance, management is required to acknowledge and accept its responsibilities, which include responsibility for the preparation and fair presentation of the pro forma financial information in accordance with the applicable financial reporting framework. Even if the accountant prepares the pro forma financial information, which would be done in a nonattest bookkeeping engagement, the client is required to take responsibility for the preparation and fair presentation of the information.

Due to the unique nature of pro forma financial information, the client is required to agree that, in any document containing the compiled pro forma financial information, the following will be included:
• The complete financial statements for the entity for the immediately preceding period.
  o In some cases, the financial statements for the most recent period may not have yet been prepared. When that is the case, the financial statements for the period preceding that are to be included.

• If the pro forma financial information is for an interim period, the historical financial information for that period is to be included.
  o It may be in condensed form.
  o If the financial statements for that interim period are not available, those for the most recent period available should be included.

• If the pro forma financial information is related to a business combination, the financial information for all significant constituent entities should be included.
  o The financial statements that are included, either those of the entity or those of all constituent entities in the case of a business combination, are to have been subjected to a compilation, review, or audit engagement.

• The accountant's audit, review, or compilation report on the included financial statements should also be included.
  o Making the report available is sufficient.

Pro forma financial information is to be accompanied by a summary of significant assumptions so that users will understand not only the framework but also management's plans that are being considered or events that are being planned for.

The client is expected to agree to obtain the accountant's permission to include the compilation report in any document containing the pro forma financial information when it indicates that the information has been compiled. The permission should be obtained prior to the inclusion of the information.

If any of the conditions are not met to the accountant's satisfaction, the matters should be discussed with the client's management so that the accountant can make an appropriate decision regarding whether to accept the engagement.

**Agreement on Engagement Terms**

In an engagement letter, continuing the signatures of both the accountant, or the accountant's firm, and the appropriate representative from the client, either management or those responsible for governance, the terms of the engagement should be agreed upon and documented. The engagement letter should include:

• The objectives of the engagement;
• Management's responsibilities;
• The accountant's responsibilities;
• The limitations of the compilation engagement;
• Identification of the applicable financial reporting framework, according to which the pro forma financial information has been prepared; and
• The expected form and content of the accountant's compilation report with an indication that circumstances may require a report that may differ in form or content.

As is the case in all compilations, the accountant is required to have or obtain an understanding of the financial reporting framework in accordance with which the pro forma financial information is being prepared. This will include the client's significant accounting policies and, if a business combination is involved, those of the constituent entities.
Compilation Procedures
The same procedures as those required for any compilation are required, however, they may need some modification to adapt to the fact that the information is pro forma, as opposed to historical, financial information. In addition, the accountant should:

- Obtain an understanding of the event or transaction underlying the pro forma financial information;
- Ascertain that management has fulfilled its responsibilities to include the historical financial information indicated above, that the information has been subjected to a compilation, review, or audit engagement, and that the report has been included in the document or made readily available.

The Accountant's Compilation Report
The accountant's compilation report is required to be in writing and to comply with all of the requirements delineated in AR-C Section 80, as discussed above. In addition, the report should include a reference to the historical financial statements from which the information was derived, indicating whether the information had been subjected to an audit, a review, or a compilation. Any modifications of the report on the historical information should be referenced and the nature and limitations of pro forma financial information should be described.
ACCOUNTANT’S COMPILATION REPORT
(Pro Forma)

Management is responsible for the accompanying pro forma condensed balance sheet of X Company as of December 31, 20X1, and the related pro forma condensed statement of income for the year then ended (pro forma financial information), based on the criteria in Note 1. The historical condensed financial statements are derived from the financial statements of X Company, on which we performed a compilation engagement, and of A Company, on which other accountants performed a compilation engagement. The pro forma adjustments are based on management’s assumptions described in Note 1. We have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not examine or review the pro forma financial information nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on the 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 underlying transaction (or event) occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction (or event) actually occurred at such earlier date.

An additional paragraph may be added to emphasize certain matters relating to the compilation engagement or the subject matter. If it refers to information that is properly accounted for and disclosed, an emphasis-of-matter paragraph will be used. If it is to provide information about the engagement or the subject matter that is not required to be disclosed but, in the accountant’s judgment, will be useful to the users of the information, it will be in an other-matter paragraph.

The report will also include the accountant’s city and state, the date of the report, and the accountant’s signature or that of the firm.

**Documentation Required for a Compilation of Pro Forma Financial Information**

As is true for all professional engagements, documentation should be sufficient to provide a clear understanding of the work performed. It should include, as a minimum:

- The engagement letter or other documentation of the understanding;
- The results of procedures performed;
- A copy of the pro forma financial information; and
- A copy of the compilation report.

**Compilation Reports on Financial Statements Included in Certain Prescribed Forms**

***
1. **(a)** Reviews are considered attest engagements. A review is also an assurance engagement. Compilation and preparation engagements are neither attest engagements nor assurance engagements.
### Task-Based Simulation Solution 2

| AR-C | 80 | .40 |

### Task-Based Simulation Solution 3

| AR-C | 70 | .14 |

### Task-Based Simulation Solution 4

| AR-C | 80 | .27 |

### Task-Based Simulation Solution 5

| AR-C | 90 | .29 |

### Task-Based Simulation Solution 6

| AR-C | 90 | .86 |
Starting on Page 8-1, the following replaces Lectures 8.01–8.05, most of which has been significantly revised.

**Lecture 8.01**

**SUPPLEMENTAL INFORMATION (SI)**

There are 6 different standards that apply to supplemental information (i.e., information that is not part of the basic financial statements, whether required to be presented or not): 3 of them apply to audits of nonpublic entities (i.e., nonissuers) issued by the ASB and the other 3 apply to publicly traded entities (i.e., issuers) under the PCAOB auditing standards. Each standard setter has provided standards in relation to 3 categories of supplemental information (SI). While there are slight differences in how they define these categories, they basically boil down to the following:

- **Other Information (OI)**—unaudited SI voluntarily provided
  - E.g., financial summaries or highlights, financial ratios, etc.
- **Supplemental Information (SI)**—audited SI, voluntary or required
  - E.g., additional details on items in or related to basic F/S, consolidating info, historical summaries, statistical data.
- **Required Supplemental Information (RSI)**—unaudited SI required
  - E.g., certain disclosures required by FASB, GASB, or FASAB outside the basic F/S.

We will focus our discussion on the 3 standards issued by the ASB and highlight the differences found in the PCAOB’s parallel standards. The following diagram has been provided to show how all this information is related and can overlap.

---

**Supplemental Information**

<table>
<thead>
<tr>
<th>Basic F/S (including notes)</th>
<th>Other Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>QI - unaudited</td>
<td>SI - Audited</td>
</tr>
<tr>
<td>- AU-C 720</td>
<td>- AU-C 725</td>
</tr>
<tr>
<td></td>
<td>- AS 2710</td>
</tr>
<tr>
<td>RSI - unaudited</td>
<td></td>
</tr>
<tr>
<td>- AU-C 730</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- AS 2705</td>
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</tbody>
</table>

**Other Information (OI) in Documents Containing Audited F/S (AU-C 720)**

A document containing audited financial statements (F/S), such as the annual report, may also contain other information (AU-C 720) that is not part of the basic F/S. This may include supplementary information, but would not include required supplementary information (AU-C 730). Examples may include financial summaries or highlights, financial ratios, etc.

Unless the auditor is engaged to perform procedures in relation to other information (OI), the auditor’s report generally does not cover it. A difference between the other information and the
information in the audited F/S, however, could undermine the credibility of the F/S; therefore, the auditor should read the other information to determine if there are any material inconsistencies. If there are, the auditor should determine if the F/S or the other information needs correction.

- If it is determined that the F/S need correction, discovered prior to the date of the audit report, the client should revise the F/S and their refusal to do so will require a modification of the report.
- If it is determined that the F/S need correction, discovered after the date of the audit report but prior to its release, the auditor should follow the guidelines in AU-C 560, Subsequent Events and Subsequently Discovered Facts.
- If it is determined that the other information needs correction, discovered prior to the release of the audit report, and the client refuses to do so, the auditor should communicate the matter to those charged with governance and modify the report with an other-matter paragraph describing the inconsistency, withhold the report, or withdraw from the engagement.

When material inconsistencies are discovered after the release of the report that require modification of the F/S, the auditor should follow the guidance in AU-C 560, Subsequent Events and Subsequently Discovered Facts. When material inconsistencies are discovered after the release of the report that require modification of the other information:

- If management agrees to make the changes, the auditor should perform appropriate procedures, such as determining if management is making appropriate provisions to notify financial statement users.
- If management refuses to make the changes, the auditor should inform those charged with governance and take any further action deemed necessary, such as consulting with an attorney.

Upon reading the other information, the auditor may become aware of a material misstatement of fact, which should be discussed with management. If, after such discussions, the auditor continues to believe that there is a material misstatement of fact, the auditor should request that management consult with an appropriate qualified third party to determine if the other information does, in fact, contain a material misstatement of fact. If it is determined that there is such a material misstatement of fact, the auditor should discuss the matter with those charged with governance and take other actions as appropriate.

Other Information in Documents Containing Audited F/S (PCAOB AS 2710)
While an auditor of a public entity is technically required to follow PCAOB AS 2710 rather than AU-C 720, there are no fundamental differences to note between the two.

Supplementary Information (SI) in Relation to F/S as a Whole (AU-C 725)
The auditor may be engaged to report on whether supplementary information (SI) is fairly stated, in all material respects, in relation to the F/S as a whole. The auditor may only accept such an engagement if the following conditions are met:

- The SI and the F/S were derived from the same records.
- They relate to the same period.
- The F/S were audited and a report was issued that was neither adverse nor contained a disclaimer of opinion.
- Either the SI will accompany the F/S or the F/S will be readily available.
In addition to the procedures performed during the audit, in order to express an opinion regarding the SI, the auditor should perform additional procedures that include:

- Making inquiries of management regarding the purpose of the SI, how it was prepared, and significant assumptions.
- Evaluating whether form and content comply with applicable criteria, whether the criteria have been consistently applied, and whether the SI is appropriate and complete.
- Comparing and reconciling the SI to the underlying accounting records.
- Obtaining written representations from management regarding:
  - Its responsibility for the SI
  - Its belief that it is fairly presented in accordance with applicable criteria
  - Its consistency
  - Its significant assumptions
  - The availability of the audited F/S if they do not accompany the SI

If the SI is presented with the F/S, the auditor should report on the SI in either an other-matter paragraph or in a separate report. If the F/S are not presented with the SI, the auditor should report on the SI in a separate report, which should include a reference to the report on the F/S, the date of that report, the nature of the opinion, and any report modifications.

Remember that the accuracy or inaccuracy of SI does not affect the auditor's opinion on the basic F/S, since such information is outside those statements. However, if the auditor expresses an adverse or disclaimer of opinion on the basic F/S, the auditors are precluded from expressing an opinion on the SI.

If the SI is determined to be materially misstated, the auditor should discuss the matter with management and propose a revision. If management refuses to revise the SI, the auditor should modify the opinion on the SI and describe the misstatement in the report, or withhold the report on the SI if a separate report is to be issued.

**Auditing Supplemental Information Accompanying Audited F/S (PCAOB AS 2701)**

An auditor of a public entity is required to follow PCAOB AS 2701, which is very similar to AU-C 725, but there are some additional requirements.

- The required procedures set forth for SI are basically the same as under AU-C 725; however, the PCAOB requires the auditor to perform “audit procedures necessary to obtain sufficient appropriate audit evidence” to support the auditor's opinion on the SI. The nature, timing, and extent of these procedures are dependent upon the risk of material misstatement of the SI, materiality considerations, audit evidence supporting the F/S, and the type of opinion expressed on the F/S.
- In addition to the written representations required from management under AU-C 725, AS 2701 specifically requires the auditor to obtain a statement from management that
  - Identifies any applicable regulatory requirements for the form and content of the SI and
  - Provides that the SI complies, in all material respects, with such requirements.
- With regard to the evaluation of audit results on SI, AS 2701 provides that the auditor should:
  - Evaluate whether the SI, including its form and content, is fairly stated in relation to the F/S as a whole, and is presented in conformity with relevant regulatory requirements or other applicable criteria.
Accumulate misstatements identified regarding the SI and communicate them to management to give them an opportunity to make corrections.

Evaluate whether uncorrected misstatements are material, taking into account relevant quantitative and qualitative factors.

Evaluate the effect of uncorrected misstatements related to the SI in evaluating the results of the financial statement audit.

Evaluate the effect of any modifications to the audit report on the F/S when forming an opinion on the SI.

- If a qualified opinion is expressed on the F/S and the basis for the qualification also applies to the SI, the auditor should describe the effects of the qualification on the SI and express a qualified opinion on the SI as well.
- If an adverse opinion is expressed on the F/S or an opinion is disclaimed, the auditor should also express an adverse opinion, or disclaim an opinion, on the SI, as appropriate.

If it is determined that the SI is materially misstated in relation to the F/S as a whole, the auditor should describe the material misstatement in the auditor's report on the SI and express a qualified or adverse opinion on the SI.

If the auditor is unable to obtain sufficient appropriate audit evidence to support an opinion on the SI, the auditor should disclaim an opinion on the SI. In those situations, the auditor's report on the SI should describe the reason for the disclaimer and state that the auditor is unable to and does not express an opinion on the SI.

The auditor may express an opinion on some SI but disclaim an opinion on other SI. For example, if the SI consists of more than one schedule, and the auditor is able to support an opinion on one schedule but not the other, the auditor may express an opinion on the schedule for which sufficient appropriate evidence was obtained and disclaim an opinion on the other schedule.

### Required Supplementary Information (RSI) (AU-C 730)

In some cases, supplementary information is required by the applicable financial reporting framework (AFRF). This is, for example, often the case when the framework is established by a regulatory agency, such as FASB, GASB, or FASAB. With regard to **Required Supplementary Information (RSI)**, the auditor must apply **limited procedures** to see if the required info has been provided and whether or not it appears to be correct. Examples of this information as it relates to GASB include management's discussion and analysis, budgetary comparison schedules, and schedules of funding progress and employer contributions for other post-employment benefits and pensions.

The **required procedures** include:

- Inquiring of management about its methods of preparing the information:
  - Are the methods of measurement or presentation in accordance with prescribed guidelines?
  - Are such methods consistent with prior periods and, if not, why?
  - Were there any significant assumptions or interpretations underlying the measurement or presentation of the information?

- Comparing information for consistency

- Obtaining written representations from management regarding their responsibility for the RSI and the methods of preparation
The procedures do not constitute an audit of the RSI; thus, no opinion on the RSI is required and the opinion on the F/S will not be affected. However, the auditor should include an other-matter paragraph explaining the following circumstances, as applicable:

- The RSI is included and the auditor applied the appropriate procedures.
- The RSI is omitted.
- Some RSI is missing.
- The information is not in compliance with applicable requirements.
- The auditor is not able to complete required procedures.
- There is substantial doubt about the conformity of the RSI.

**Required Supplementary Information (PCAOB AS 2705)**

With respect to supplemental information required by FASB, GASB, and FASAB, an auditor of a public entity is required to follow PCAOB AS 2705, which is very similar to AU-C 730, but there are some differences.

- If an entity voluntarily provides SI that is RSI to other entities, the auditor is required to either apply the procedures under AS 2705 or provide a disclaimer on the information in an explanatory paragraph, unless the entity itself specifies that the information was not subjected to such procedures.
- In addition to the limited procedures required by AU-C 730, PCAOB AS 2705 requires the auditor to:
  - Consider whether representations on RSI should be included in specific written representations obtained from management under AS 2805, Management Representations;
  - Apply additional procedures, if any, that other statements or interpretations prescribe for specific types of RSI; and
  - Make additional inquiries if the auditor believes that the information may not be measured or presented within applicable guidelines.

- While under AU-C 730 the auditor is required to include an other-matter paragraph even if no issues are found with the RSI, AS 2705 requires an explanatory paragraph only in the following circumstances:
  - The RSI is omitted.
  - There is a material departure from prescribed guidelines.
  - The auditor is not able to complete required procedures.
  - There is substantial doubt about the conformity of the RSI.

Note: AS 2701 (Auditing SI Accompanying Audited F/S) applies instead of AS 2705 if the auditor is engaged to audit the RSI.

**Segment Information (>10%)—Notes to the F/S**

Annual financial statements of public entities are required to contain segment information (FASB ASC 280) about a company’s operations in different industries, foreign operations and export sales and major customers. This is part of the basic F/S. If it is omitted or contains a material misstatement (disagreement), the auditor will either qualify or give an adverse opinion on the financial statements taken as a whole.
Summary
To summarize the approach to other information (OI), supplementary information (SI), and required supplementary information (RSI):

<table>
<thead>
<tr>
<th>Situation</th>
<th>Effect on Fieldwork</th>
<th>Effect on Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voluntary by client (OI)</td>
<td>Read for consistency</td>
<td>- Report inconsistencies in Other-matter para., withhold report, or withdraw</td>
</tr>
<tr>
<td>Engaged to Audit (SI)</td>
<td>Audit Procedures</td>
<td>- Other-matter para. or Separate report</td>
</tr>
<tr>
<td>Required by FASB/GASB (RSI)</td>
<td>Limited procedures</td>
<td>- Other-matter para. (ASB)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Explanatory para. only for exceptions (PCAOB)</td>
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</table>

Lecture 8.02
SPECIAL REPORTS
An accountant may be asked to prepare a special report in certain engagements, including:

1. Reporting on F/S that are prepared in conformity with some special purpose framework, often referred to as an other comprehensive basis of accounting (OCBOA) other than GAAP.
2. Reporting on a single F/S, or on specified elements, accounts, or items on a financial statement.
3. Completing prescribed report forms of a government agency on behalf of the client.
4. Reporting on the client's compliance with aspects of contracts or regulatory requirements in connection with an audit.

1. Audits of F/S Prepared in Accordance With Special Purpose Frameworks (OCBOA) (AU-C 800)
A special purpose framework is a financial reporting framework other than GAAP, often referred to as an OCBOA. Examples are the income tax basis, the cash basis, a contractual basis, a basis used by a regulatory agency (restricted use), or an “other basis of accounting.” To be considered a special purpose framework, there must be a definite set of criteria that would enable the auditor to determine conformity with the approach.

- An entity may prepare its F/S using a framework based on GAAP with certain differences.
  - This is not considered a special report.
  - The auditor will consider differences to be departures from GAAP and would issue a qualified or adverse opinion, as appropriate.

Prescribed forms of government agencies often require special handling, because they may include specific representations that the accountant is expected to make.

Third parties dealing with the client may request reports on compliance with agreements related to the F/S. For example, a creditor may wish the auditor to provide a report on whether the client's working capital ratio has been maintained through the year at the level required in connection with a loan agreement.
Forming an Opinion and Reporting

When an auditor accepts an engagement to examine F/S that are intended to conform to a comprehensive basis of accounting other than GAAP, the audit will still conform to generally accepted auditing standards (GAAS), and the opinion may still be unmodified, qualified, or adverse, depending on whether the statements conform to the OCBOA.

When forming an opinion and reporting on F/S prepared in accordance with a special purpose framework, the auditor should evaluate the following considerations.

- Whether the F/S adequately refer to or describe the AFRF, including:
  - Whether the F/S are suitably titled (e.g., "Statement of Income—Regulatory Basis" instead of “Statement of Income”).
  - Whether the F/S include a summary of significant accounting policies.
  - Whether the F/S adequately describe the material differences in how the special purpose framework differs from GAAP.
  - If the F/S are prepared in accordance with a contractual basis of accounting, whether the F/S adequately describe any significant interpretations of the contract on which the F/S are based.

- Whether the F/S are fairly presented:
  - When the special purpose F/S contain items that are similar to those in F/S prepared in accordance with GAAP, whether the F/S include informative disclosures similar to those required by GAAP.
  - Whether additional disclosures are necessary to achieve fair presentation (e.g., disclosures regarding related-party transactions, restrictions on assets/owners' equity, subsequent events, and significant uncertainties).

- Whether the auditor's report requires:
  - A description of the purpose for which the F/S were prepared or a reference to a note in the F/S with this information (generally for regulatory or contractual basis of accounting).
  - An emphasis-of-matter paragraph that alerts users regarding the basis of accounting other than GAAP used to prepare the F/S (applies in most cases).
  - An other-matter paragraph that restricts the use of the report to certain parties to avoid misunderstandings (generally when the F/S are prepared under a regulatory or contractual basis of accounting).
  - An opinion as to whether the F/S are presented fairly in accordance with GAAP in addition to the opinion regarding the special purpose framework, instead of the other-matter and emphasis-of-matter paragraphs described above (only applicable for Regulatory Basis F/S for General Use).

A sample report following an audit of F/S designed to conform to the cash receipts and disbursements method follows:
INDEPENDENT AUDITOR’S REPORT
(OCBOA)

To the Board of Directors of X Company:

Report on the Financial Statements (Introductory)

We have Audited the accompanying financial statements of X Co, which comprise the statement of assets and liabilities arising from cash transactions as of December 31, 20X1, and the related statement of revenue collected and expenses paid for the year then ended, and the related notes to the financial statements.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the cash basis of accounting described in Note X; this includes determining that the cash basis of accounting is an acceptable basis for the preparation of the financial statements in the circumstances. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of X Company as of December 31, 20X1, and its revenue collected and expenses paid for the year then ended, in accordance with the cash basis of accounting described in Note X.

Basis of Accounting (emphasis-of-matter)

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on the cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

L.F. Rosenthal, CPA
Auditor's city & state
March 1, 20X2
When an accountant is asked to follow an audit report form, layout or wording prescribed by law or a regulatory agency, and the prescribed form is unacceptable, the auditor should:

- Reword the prescribed form, or
- Attach a separate, appropriately worded audit report.

Note: An accountant may be asked to compile or review OCBOA statements of a nonpublic entity. In that case, the accountant will apply SSARS to such an engagement, as discussed earlier.

2. Audits of Single F/S and Specified Elements, Accounts, or Items of a F/S (AU-C 805)

An auditor may accept an engagement to examine a single F/S or specified elements, accounts, or items of a F/S as long as the client imposes no restriction on the scope of the auditor's procedures. This may be either a separate engagement or one performed in conjunction with an audit of the F/S of the client.

Audits of a single F/S, specified elements, accounts, or items are sometimes needed to satisfy a creditor, landlord, or employee about the calculations related to certain agreements. A landlord might want an opinion on the calculation of rent expense under a percentage agreement, or an officer might want verification of a profit-sharing calculation related to net income. Also, a CPA is sometimes asked for an opinion on the application of GAAP to a specific transaction when the client of another CPA firm disagrees with that firm about the appropriate treatment.

Forming an Opinion and Reporting

The opinion on the single F/S or specified element may be expressed in a separate report that accompanies the report on the complete set of F/S, as long as the opinion is either unmodified or qualified. Such separate report and presentation of the single F/S should be sufficiently differentiated from the report on the complete F/S.

If the auditor has issued either an adverse opinion or a disclaimer of opinion on the complete F/S, the auditor cannot issue an unmodified opinion on the single F/S or specified element in a report that accompanies the report on the complete F/S; to do so would be confusing to the reader of the reports and would be considered essentially equivalent to a "piecemeal opinion." If an unmodified opinion on a specified element is still appropriate despite the adverse opinion or disclaimer on the complete F/S, the auditor can express such opinion only if:

- The opinion is expressed in a report that is neither published with nor accompanies the auditor's report containing the adverse opinion or disclaimer of opinion, and
- The specific element is neither considered to be a major portion of the complete F/S nor based on stockholders’ equity or net income or equivalent.

Note: A single F/S is considered to be a major portion of the complete F/S, so an unmodified opinion cannot be expressed on a single F/S when an adverse/disclaimer of opinion has been expressed on the complete F/S, regardless of how or where it is published.

If an accountant is asked to give an opinion on the application of GAAP to a specific transaction by a client of another CPA firm, the accountant must consult with the other CPA firm on the transaction in question. If the accountant is being asked for this opinion as part of a proposal to become the new auditor of the client, the report must specifically indicate that the conclusion might change if there is a change in facts, circumstances, or assumptions behind the report. This is needed to prevent a client from being able to "shop around" for accounting principles.
Note: SSARS apply when the CPA is engaged to prepare, compile, or review F/S elements, accounts, or items.

3. Completing a Prescribed Audit Report Form of a Government Agency on Behalf of the Client (AU-C 800)

When an accountant is asked to follow an audit report form, layout or wording prescribed by law or a regulatory agency, the report should only refer to GAAS if the report includes all of the following:

- Title
- Addressee
- Introductory paragraph identifying the special purpose financial statements audited
- Description of management's responsibility
  - For the preparation and fair presentation of the special purpose statements
  - For determining that the applicable financial reporting framework is acceptable under the circumstances
- When prepared in accordance with a regulatory or contractual basis, a description of the purpose for which the financial statements are prepared
- Description of the auditor's responsibility to express an opinion, including:
  - Reference to GAAS and, if appropriate, the law or regulation
  - Description of an audit in accordance with the standards
- Opinion paragraph
- Emphasis-of-matter paragraph
- Other-matter paragraph restricting the use of the report
- Auditor's signature and city and state
- Date of report

If the report is intended for general distribution, the auditor will not include the emphasis-of-matter or other-matter paragraph and will, instead, express an opinion as to whether or not the financial statements are in conformity with GAAP.

If the prescribed form of the report differs significantly from GAAS, and the auditor is worried that users might misunderstand the audit report, the auditor may:

- Reword the prescribed form and sign it, or
- Attach a separate audit report to the form, or
- The auditor should NOT accept the audit engagement (unless required by law or regulation).

4. Reporting on Compliance with Aspects of Contracts or Regulatory Requirements in Connection with Audited F/S (AU-C 806)

When the auditor is asked to verify compliance with contractual agreements (such as a loan agreement) or regulatory requirements related to the F/S, the resulting report is generally referred to as a “by-product report.” Such report should include:

- The accountant's findings in an other-matter paragraph or a separate report.
  - The auditor should state that nothing came to the auditor's attention to suggest the client had not complied with all requirements if (1) the auditor found no instances of noncompliance, (2) an unmodified or qualified opinion has been expressed on the related F/S, and (3) the applicable requirements relate to accounting matters subjected to audit procedures during the audit of the F/S.
Otherwise, each instance of noncompliance should be described.

- If an adverse opinion or disclaimer of opinion has been expressed on the F/S, a compliance report should NOT be issued unless there are instances of noncompliance.

- A statement indicating that the audit was not directed primarily toward obtaining knowledge regarding compliance, and thus, had additional procedures been performed, other matters may have come to the auditor's attention regarding noncompliance.

- A description and the source of significant interpretations made by management relating to the provisions of the contractual or regulatory requirement.

- An alert that restricts the use of the report.

CPA candidates could be asked to prepare this type of compliance report on the exam starting with a report example, such as those that follow.

### Paragraphs Added for Combined Report When NO Instances of Noncompliance

**Independent Auditor's Report**

To: Appropriate addressee

***

**Other Matter**

In connection with our audit, nothing came to our attention that caused us to believe that ABC Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to YY, inclusive, of the Indenture dated July 21, 20XX with XYZ Bank, insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Company's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Indenture, insofar as they relate to accounting matters.

**Restricted Use Relating to the Other Matter**

The communication related to compliance with the aforementioned Indenture described in the Other Matter paragraph is intended solely for the information and use of the boards of directors and management of ABC Company and XYZ Bank and is not intended to be and should not be used by anyone other than these specified parties.

*Armin Lindegger, CPA*
Santa Ana, CA
March 1, 20XX
Independent Auditor’s Report

To: Appropriate addressee

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders’ equity, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated February 16, 20XX. In connection with our audit, nothing came to our attention that caused us to believe that XYZ Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to YY, inclusive, of the Indenture dated July 21, 20XX, with ABC Bank, insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Company’s noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Indenture, insofar as they relate to accounting matters.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

Patrick Aaron, CPA
Santa Ana, CA
March 1, 20XX
Independent Auditor's Report

To: Appropriate addressee

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 5, 20XX.

In connection with our audit, we noted that XYZ Company failed to comply with the "Working Capital" provision of section XX of the Loan Agreement dated March 1, 20XX, with ABC Bank. Our audit was not directed primarily toward obtaining knowledge as to whether XYZ Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to YY, inclusive, of the Loan Agreement, insofar as they relate to accounting matters. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Loan Agreement, insofar as they relate to accounting matters.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

Noah P. Benedict, CPA
Santa Ana, CA
March 1, 20XX

Note: AU-C 935, Compliance Audits, applies if the auditor is engaged, or required by law, to perform a compliance audit in accordance with GAAS, GAGAS, or some other governmental audit requirement that requires the expression of an opinion on compliance. AT-C 315, Compliance Attestation, applies if the auditor is engaged to perform a separate attestation engagement on an entity's compliance with certain requirements or the effectiveness of the entity's internal control over compliance with certain requirements. These engagements are discussed later in this section.

Lecture 8.03

ATTESTATION ENGAGEMENTS (SSAE)

Ever since the first accounting firm was asked to count the ballots at the Academy Awards, CPA firms have been expanding into areas beyond historical financial statements. These now include engagements to verify the accuracy and security of Web sites (WebTrust), the truth of advertising claims, the completeness of personal disclosures by political candidates, internal control opinions, prospective information and compliance with contracts or laws and regulations. Compilation engagements provide no assurance and are not attest engagements. They are not addressed in the attestation standards.

- AT-C 200 – Level of Service (ERA)
  - AT-C 205 – Examination Engagements
AT-C 210 – Review Engagements  
AT-C 215 – Agreed-Upon Procedures Engagements

• AT-C 300 – Subject Matter  
  - AT-C 305 – Prospective Financial Statements  
  - AT-C 310 – Reporting on Pro Forma Financial Information  
  - AT-C 315 – Compliance Attestation  
  - AT-C 320 – Reporting on an Examination of Internal Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting (see Section 3)  
  - AT-C 395 – Management’s Discussion and Analysis (MD&A)

Note: The attestation standards were clarified and recodified in SSAE No. 18, effective for reports dated as of May 1, 2017.

Common Concepts (AT-C 105)

The AICPA uses the term **attestation** to refer to any engagement in which the accountant expresses a **written conclusion about the reliability of a written assertion** by another party. There are three categories of attest engagements (ERA):

- **Examination** – An engagement in which the end result is the expression of an **opinion** (*reasonable assurance*) by the accountant about the subject matter or assertion of another party. The work performed will involve a level of service comparable to audits of historical F/S.

- **Review** – An engagement in which the end result is the expression of a **conclusion** with **limited assurance** (i.e., **negative assurance**) on the subject matter or assertion. Procedures such as inquiry of the other party as to the methods used and analytical procedures applied to numerical information related to the assertion will be performed.

- **Agreed-upon procedures** – An engagement in which the end result is a report of the accountant's **findings** (no opinion or conclusion) regarding agreed-upon procedures applied to subject matter for the use of specified parties. The procedures will depend on the agreement made among the parties to the engagement. The distribution of the report is **restricted** to specific users knowledgeable about the agreement. In all such engagements, the accountant will disclaim any responsibility for the sufficiency of the procedures.

The mnemonic **ERAS** reminds us that attestation standards are part of a new era in which accountants are performing engagements that go beyond reports on historical F/S.

Note: The following attestation standards do not apply to (1) audits under the SASs, (2) compilations and reviews of F/S under the SSARS, or (3) tax services under the SSTSSs.

Preconditions for Acceptance

- All attestation engagements require that the accountant be **independent** of the party whose assertion is being evaluated, unless the accountant is required by law or regulation to accept the engagement.

- The responsible party (e.g., senior management; not the accountant) assumes responsibility for the subject matter.

- The subject matter is appropriate; i.e., can it be identified and measured or evaluated against specific criteria?

- The criteria to be applied is appropriate and will be available to the users.
• The accountant expects to be able to obtain sufficient evidence to provide an opinion, conclusion, or findings. This means the accountant will have access to all relevant information as well as individuals who may provide such evidence.
• The accountant's opinion, conclusion, or findings will be contained in a written report, as appropriate.

Prescribed Forms
When an accountant is required to use a specified report form, layout or wording prescribed by law or a regulatory agency, and the prescribed form is unacceptable, the auditor should:
• Reword the prescribed form, or
• Attach a separate, appropriately worded report.

Change of Engagement
If the client decides to change the terms of the engagement after acceptance, the accountant should only agree to such a change when there is reasonable justification for doing so. If the change is made during the engagement, evidence obtained prior to the change cannot be disregarded. However, so long as the accountant complies with the standards for the new level of service, the accountant should issue the appropriate report and should NOT make reference to:
• The original engagement,
• Any procedures performed, or
• Any scope limitations that resulted in the changed engagement.

Using the Work of Another
When the accountant uses the work of another accountant, the accountant should:
• Determine whether the other accountant is independent and understands the applicable ethical requirements.
• Determine whether the other accountant is professionally competent.
• Communicate the scope and timing of the other accountant's work.
• Evaluate whether the other accountant's work is adequate.
• Determine whether the report should reference the work of the other practitioner.

Engagement Documentation Requirements
With regard to engagement documentation, the accountant should:
• Prepare it on a timely basis (i.e., as the work is performed or shortly after).
• Assemble the final engagement file within 60 days of the accountant's report release date.
• Retain all documentation after the documentation completion date for the appropriate retention period. If it is necessary to add or discard any documentation after such time, the specific reasons for the changes, who made the changes, and the date of such changes should be documented.
• Adopt reasonable procedures to keep the documentation confidential and prevent unauthorized access.
• Include written justification for departing from any presumptively mandatory requirements (i.e., requirements specified with “should” rather than “must”) and how alternative procedures achieved the intent of the requirement.

Examination Engagements (AT-C 205)
In addition to the concepts just covered that are applicable to all attestation engagements, all examination engagements (including, for example, the examination of prospective financial information, which is also covered under AT-C 305, discussed later) are subject to yet another set
of requirements specific to examinations. An examination, you might remember, is a level of service comparable to audits of historical F/S, involving the expression of an opinion (reasonable assurance) about the subject matter or written assertion of another party. With this type of engagement, the accountant should:

- Specify the agreed-upon terms of the engagement in an engagement letter or other written agreement, including the objective and scope of the engagement; responsibilities of the practitioner; a statement that the engagement will be conducted in accordance with attestation standards established by the AICPA; responsibilities of the responsible/engaging party; inherent limitations of the engagement; the criteria for measuring, evaluating, or disclosing the subject matter; and an agreement by the engaging party (e.g., those charged with governance) to provide a representation letter at the conclusion of the engagement.

- Request a written assertion from the responsible party regarding measurement/evaluation of the subject matter. If the responsible party is not the engaging party and refuses to comply, the accountant must disclose the refusal in the report and restrict the report to the engaging party. If the responsible party is also the engaging party and they refuse to comply, the accountant must withdraw from the engagement, or disclaim an opinion if law/regulation prevents withdrawal.

- Establish an overall engagement strategy, which sets the scope, timing and direction of the engagement and assists in the development of the engagement plan.

- Develop an engagement plan that includes the nature, timing and extent of procedures to be performed, including risk assessment procedures.

- Obtain an understanding of the subject matter and relevant circumstances (including internal controls over the preparation of the subject matter) to be able to (1) identify and assess the risks of material misstatement and (2) design procedures to respond to such risks and obtain reasonable assurance to support the opinion.

- Consider materiality for the subject matter when establishing the overall engagement strategy, and reconsider materiality if new information brings it into question.

- Obtain sufficient appropriate evidence to reduce attestation risk to an acceptably low level.

- Design and perform tests of controls if (1) the accountant intends to rely on the operating effectiveness of controls in determining the nature, timing, and extent of other procedures; (2) if other procedures will not provide sufficient appropriate evidence alone; or (3) if the subject matter itself is internal control.

- Design and perform tests of details or analytical procedures (unless the subject matter is internal control).

- Consider and inquire as to whether there are any indications of fraud or noncompliance with laws/regulations.

- Consider and inquire about subsequent events (i.e., events occurring after the period covered by the engagement up to the report date) and subsequently discovered facts (i.e., facts discovered after the report date).

- Request written representations (in the form of a letter to the accountant as of the date of the report) from (1) the responsible party regarding the assertion, relevant matters, their responsibilities, subsequent events, immaterial uncorrected misstatements, etc.; and (2) the engaging party (if a separate party) regarding the responsible party’s responsibilities, their lack of knowledge of any material misstatements, subsequent events, etc.
• **Read other information** in the document that will contain the accountant’s report to identify any material inconsistencies.

• **Evaluate the results** of the procedures, **form an opinion**, and **prepare a written report** on a written assertion or on the subject matter directly. See following examples.
  
  o If the accountant was unable to obtain sufficient appropriate evidence or the subject matter is not in accordance with the specified criteria, in all material respects, and the effect of any such insufficiencies are material, the opinion should be modified and a separate paragraph describing such matters should be included in the report.
    - Effects are **material, but not pervasive**—Qualified opinion
    - Misstatements are **material and pervasive**—Adverse opinion
    - Unable to obtain sufficient appropriate evidence (i.e., scope limitation) and effects **could be material and pervasive**—Disclaimer of opinion
  
  o When the opinion is modified, external specialists can be referenced in the report if it is relevant to the opinion; however, they should not be referenced when the opinion is unmodified.
  
  o The report should include a separate paragraph that restricts the use of the report (1) if the criteria used are appropriate for, or available to, only specified parties, or (2) if the responsible party is *not* the engaging party and refuses to comply with the request for written representations, but does provide oral responses, the report should be restricted to the engaging party.
Examination Report on Subject Matter—Unmodified Opinion

Independent Accountant's Report

To: Appropriate addressee

We have examined [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX]. XYZ Company's management is responsible for [identify the subject matter, for example, presenting the schedule of investment returns] in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1]. Our responsibility is to express an opinion on [identify the subject matter, for example, the schedule of investment returns] based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether [identify the subject matter, for example, the schedule of investment returns] is in accordance with (or based on) the criteria, in all material respects. An examination involves performing procedures to obtain evidence about [identify the subject matter, for example, the schedule of investment returns]. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of [identify the subject matter, for example, the schedule of investment returns], whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

[Include a description of significant inherent limitations, if any, associated with the measurement or evaluation of the subject matter against the criteria.]

[Additional paragraph(s) may be added to emphasize certain matters relating to the attestation engagement or the subject matter.]

In our opinion, [identify the subject matter, for example, the schedule of investment returns of XYZ Company for the year ended December 31, 20XX or the schedule of investment returns referred to above], is presented in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1], in all material respects.

Asher P. Levy, CPA
Santa Ana, CA
March 1, 20XX
Examination Report on Subject Matter—Qualified Opinion

Independent Accountant's Report

To: Appropriate addressee

***

Our examination disclosed [describe condition(s) that, individually or in the aggregate, resulted in a material misstatement or deviation from the criteria].

In our opinion, except for the material misstatement [or deviation from the criteria] described in the preceding paragraph, [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX, or the schedule of investment returns referred to above], is presented in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1], in all material respects.

Alexes B. Ruiz, CPA
Santa Ana, CA
March 1, 20XX

Examination—Disclaimer of Opinion

Independent Accountant's Report

To: Appropriate addressee

We were engaged to examine [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX], in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1]. XYZ Company’s management is responsible for [identify the subject matter, for example, presenting the schedule of investment returns]. Our responsibility is to express an opinion on [identify the subject matter, for example, the schedule of investment returns] based on conducting the examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. [Include a paragraph to describe scope limitations.]

Because of the limitation on the scope of our examination discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on whether [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX, or the schedule of investment returns referred to above] is in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1], in all material respects.

Darren Chris, CPA
Santa Ana, CA
March 1, 20XX

Review Engagements (AT-C 210)

As previously discussed, a review engagement under the attestation standards is one in which the end result is the expression of a conclusion with limited assurance (i.e., negative assurance).
about whether the **subject matter or assertion** of another party is fairly stated. Such engagements are generally limited to *inquiries and analytical procedures*. Since we have already covered reviews of F/S under SSARS (in another Section), the concepts common to all attestation engagements, as well as examination engagements under the attestation standards (i.e., SSAEs) in great detail, we will only discuss the differences in the reporting requirements under the SSAEs here.

In a review engagement, the accountant will evaluate the results of the procedures and **form a conclusion** as to whether there are any material modifications that need to be made to (1) the subject matter in order for it to be in accordance with the criteria, or (2) the responsible party's assertion in order for it to be fairly stated. In forming this conclusion, the accountant should evaluate whether sufficient appropriate evidence was obtained and whether any uncorrected misstatements are material, individually or collectively.

- If the accountant is aware of an uncorrected misstatement in the subject matter, the accountant should consider whether *qualification of the conclusion* is sufficient to disclose the matter (if not, withdraw).
  - Effects are *material, but not pervasive*—Qualified conclusion
    - Include a separate paragraph in the report providing a description of the misstatement.
    - Report directly on the subject matter rather than the assertion (even if it acknowledges the misstatement).
  - Misstatements are *material and pervasive* or unable to obtain sufficient appropriate evidence (i.e., scope limitation)—Withdraw from the engagement, if possible
    - Generally includes being unable to obtain written representations. In some cases, oral representations may be accepted.

CPA candidates could be asked to prepare this type of report on the exam starting with a report example, such as one of those that follow.

Please note that reviews are generally **prohibited** for the following:

- Prospective financial information
- Internal control
- Compliance with laws, rules, regulations, contracts, and grants
Review Report on Subject Matter—Unmodified Conclusion

Independent Accountant’s Review Report

To: Appropriate addressee

We have reviewed [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX]. XYZ Company’s management is responsible for [identify the subject matter, for example, presenting the schedule of investment returns] in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1]. Our responsibility is to express a conclusion on [identify the subject matter, for example, the schedule of investment returns] based on our review.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the review to obtain limited assurance about whether any material modifications should be made to [identify the subject matter, for example, the schedule of investment returns] in order for it to be in accordance with (or based on) the criteria. A review is substantially less in scope than an examination, the objective of which is to obtain reasonable assurance about whether [identify the subject matter, for example, the schedule of investment returns] is in accordance with (or based on) the criteria, in all material respects, in order to express an opinion. Accordingly, we do not express such an opinion. We believe that our review provides a reasonable basis for our conclusion.

[Include a description of significant inherent limitations, if any, associated with the measurement or evaluation of the subject matter against the criteria.]

[Additional paragraph(s) may be added to emphasize certain matters relating to the attestation engagement or the subject matter.]

Based on our review, we are not aware of any material modifications that should be made to [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX], in order for it to be in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1].

Kristin Charberts, CPA
Santa Ana, CA
March 1, 20XX
**Review Report on Subject Matter—Qualified Conclusion**

Independent Accountant's Review Report

To: Appropriate addressee

***

Our review disclosed [describe condition(s) that, individually or in the aggregate, resulted in a material misstatement or deviation from the criteria].

Based on our review, except for the matter(s) described in the preceding paragraph, we are not aware of any material modifications that should be made to [identify the subject matter, for example, the accompanying schedule of investment returns of XYZ Company for the year ended December 31, 20XX], in order for it to be in accordance with (or based on) [identify the criteria, for example, the ABC criteria set forth in Note 1].

Wendy Robson, CPA
Santa Ana, CA
March 1, 20XX

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**Agreed-Upon Procedures Engagements (AT-C 215)**

AT-C 215 provides requirements applicable to agreed-upon procedures engagements in addition to the requirements applicable to all attestation engagements under AT-C 105, discussed earlier. Many of the requirements of AT-C 215 are similar to those for examinations (AT-C 205) and reviews (AT-C 210), which we've already covered, so we will cover some of the more important requirements specific to agreed-upon procedures engagements and then summarize and compare the three different types of attestation engagements.

As previously discussed, an agreed-upon procedures engagement is one in which the end result is a report of the accountant's findings (no opinion or conclusion) with regard to agreed-upon procedures applied to subject matter for use by specified parties. The procedures will depend on the agreement made among the parties to the engagement, and distribution of the report is restricted to the specific users knowledgeable about the agreement. In all such engagements, the specified users are responsible for the sufficiency of the procedures for their purposes, and the accountant will disclaim any responsibility for the sufficiency of the procedures. With regard to this type of engagement, the accountant should:

- NOT agree to perform procedures that are described by terms that are too generic or open to interpretation (e.g., general review, limited review, check, or test).
  - Other examples of inappropriate procedures:
    - Reading of the work performed by others to describe their findings
    - Evaluating the competency and/or objectivity of another party
    - Obtaining an understanding of a particular subject
    - Interpreting documents outside the scope of the accountant's expertise
  - Examples of appropriate procedures:
    - Inspection of specified documents evidencing certain types of transactions
    - Confirmation of specific information with third parties
Comparison of documents, schedules, or analyses with certain specified attributes
Performance of mathematical computations

- Report all findings from applying the agreed-upon procedures, avoiding any vague or ambiguous language.
- Describe any agreed-upon materiality limits in the report.
- Disclose the responsible party’s refusal to provide a written assertion in the report, if applicable.
- Describe in the report any circumstances imposing restrictions on the performance of procedures when an agreement cannot be obtained to modify the procedures. Alternatively, the accountant could withdraw from the engagement.
- Include in the report knowledge of matters brought to the accountant’s attention outside of the agreed-upon procedures if they significantly contradict the subject matter or assertion (e.g., a material weakness in internal control).

CPA candidates could be asked to prepare this type of report on the exam starting with a report example, like the one that follows.
Agreed-Upon Procedures Report Example

Independent Accountant’s Report on Applying Agreed-Upon Procedures

To: Appropriate addressee

We have performed the procedures enumerated below, which were agreed to by [identify the specified party(ies), for example, the audit committees and managements of ABC Inc. and XYZ Fund], on [identify the subject matter, for example, the accompanying Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 20X1]. XYZ Fund’s management is responsible for [identify the subject matter, for example, the Statement of Investment Performance Statistics for the year ended December 31, 20X1]. The sufficiency of these procedures is solely the responsibility of the parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures enumerated below either for the purpose for which this report has been requested or for any other purpose.

[Include paragraphs to enumerate procedures and findings.]

This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. We were not engaged to and did not conduct an examination or review, the objective of which would be the expression of an opinion or conclusion, respectively, on [identify the subject matter, for example, the accompanying Statement of Investment Performance Statistics of XYZ Fund for the year ended December 31, 20X1]. Accordingly, we do not express such an opinion or conclusion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

[Additional paragraph(s) may be added to describe other matters.]

This report is intended solely for the information and use of [identify the specified party(ies), for example, the audit committees and managements of ABC Inc. and XYZ Fund], and is not intended to be, and should not be, used by anyone other than the specified parties.

Jae Evers, CPA
Santa Ana, CA
March 1, 20XX
## SSAE Summary Comparison Chart (ERA)

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Examination</th>
<th>Review</th>
<th>Agreed-Upon Procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintain independence</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Obtain signed engagement letter</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Request written assertion regarding measurement/ evaluation of subject matter</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Obtain understanding of subject matter and relevant circumstances</td>
<td>Sufficient to assess RMM</td>
<td>Sufficient to achieve objectives of engagement</td>
<td>No</td>
</tr>
<tr>
<td>Consider materiality</td>
<td>Yes</td>
<td>Yes</td>
<td>No, unless materiality limits are agreed-upon</td>
</tr>
<tr>
<td>Obtain sufficient appropriate evidence</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Design/perform tests of controls</td>
<td>If relying on controls</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Testing of subject matter</td>
<td>Tests of details / analytical procedures</td>
<td>Generally only inquiries / analytical procedures</td>
<td>Agreed-upon procedures</td>
</tr>
<tr>
<td>Inquire about fraud or noncompliance</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Inquire about subsequent events</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Request written representations from responsible/engaging parties</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Read other information for material inconsistencies</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Written Report</td>
<td>Opinion</td>
<td>Conclusion</td>
<td>Findings</td>
</tr>
<tr>
<td>Level of Assurance</td>
<td>Reasonable</td>
<td>Limited</td>
<td>None</td>
</tr>
<tr>
<td>Restriction on Use</td>
<td>If necessary</td>
<td>If necessary</td>
<td>Yes</td>
</tr>
</tbody>
</table>
SPECIFIC TYPES OF SUBJECT MATTER

Prospective Financial Statements (AT-C 305)

Prospective financial statements present expected or hypothetical future results of an entity. There are two different types of prospective statements:

- **Forecast** – This presents what management expects to occur in the future based on expected conditions and expected courses of action.
- **Projection** – This presents what management believes will occur given certain hypothetical assumptions based on a “what if” scenario.

For example, a drug manufacturer might be expecting to receive government approval for a new drug, and will prepare a financial forecast based on expected results over the next few years given approval of the drug. The manufacturer may also prepare a financial projection on expected results over the next few years in the event the new drug does not receive approval.

Although a financial forecast is based on certain significant assumptions made by management about the future, the assumptions are general in nature, regarding factors that will affect the entity’s performance. These may include the economy; competition; the availability of resources, capital, and employees; demand; and comparable factors. As a result, a forecast is appropriate for either general or limited use.

A financial projection, is based on hypothetical propositions, which are assumptions about events or transactions that may not actually be expected to occur. As a result, a projection is only appropriate for limited use by parties with whom the entity is negotiating directly and who are aware of the use of the assumptions.

When third-party users seek some level of assurance regarding prospective F/S, an accountant may perform an attestation engagement to provide that assurance. There are two different types of engagements that an accountant may undertake in connection with prospective F/S:

- **Examination** – The accountant expresses an opinion on the prospective statements.
- **Agreed-Upon Procedures** – The accountant applies tests that are the result of an agreement between the CPA, the client, and a third party with whom the client is negotiating. Such an engagement can only result in a report for limited use, even when it involves a forecast.
  - Note: As previously mentioned, a review of prospective F/S is not allowed.

As is true for all attestation engagements, the accountant is required to comply with the requirements of the section of the attestation standards that is applicable to the specific engagement, as well as with AT-C Section 105, Concepts Common to All Attestation Engagements, discussed above.

Examinations of Prospective Financial Statements

The objective of an examination of prospective financial is for the accountant to obtain, and to convey in a written report, reasonable assurance that the presentation of prospective information conforms, in all material respects, to the guidelines established by the AICPA for the presentation of prospective information and that the assumptions underlying the forecast, or the assumptions underlying the projection, are suitably supported and provide a reasonable basis for the
responsible party's forecast, or the responsible party's projection given the hypothetical assumptions.

Before an accountant agrees to be associated with a projection, the accountant should determine that the projection will only be distributed to parties that are negotiating directly with the responsible party since a projection is not appropriate for general use.

An accountant should NOT agree to:
- Examine a forecast if the responsible party does not agree to disclose significant assumptions.
- Examine a projection if the responsible party either does not agree to disclose significant assumptions or does not identify the hypothetical assumptions or describe the limitations of the presentation.
- Examine a partial presentation that does not describe the limitations on the usefulness of the presentation.

As preconditions for an examination engagement, the accountant should understand the guidelines for preparation and presentation in the AICPA guide and have or obtain knowledge of the industry in which the entity operates and the accounting principles and practices appropriate for it.

The accountant should obtain a written assertion from the client and develop an overall strategy for the engagement that sets the scope, timing, and direction of the engagement. The procedures applied in the examination engagement should take into account the nature and materiality of the information; knowledge obtained in the current and previous engagements; the competence of the responsible party; the extent to which the prospective financial information is affected by the responsible party's judgment; and the available support for the responsible party's assumptions.

The accountant will perform those procedures the accountant considers necessary to report on whether the assumptions are suitably supported and provide a reasonable basis for the forecast, or provide a reasonable basis for the projection taking into account the hypothetical assumption. The accountant will evaluate the preparation and presentation of the prospective financial information to obtain reasonable assurance as to whether the presentation reflects the identified assumptions; computations are mathematically accurate; assumptions are internally consistent; accounting principles applied are appropriate; the prospective financial information is presented in accordance with AICPA guidelines; and that the assumptions are adequately disclosed.

The report following an examination must include the following:
- A title that includes the word independent.
- An appropriate addressee.
- Identification of the prospective financial information being reported on and the time period it relates to.
- An indication that the prospective financial information was evaluated against guidelines established by the AICPA.
- A statement identifying the responsible party, indicating their responsibility for the preparation and presentation of the prospective financial information in accordance with the AICPA guidelines.
- The accountant's responsibility for expressing an opinion on the prospective financial information.
• A statement that the examination was performed in accordance with the AICPA attestation standards, which require the accountant to plan and perform the engagement to obtain reasonable assurance that the AICPA guidelines were followed and that the accountant believes that the examination provided a reasonable basis for the opinion.
• A description of the nature of an examination.
• An opinion as to whether the statements conform to AICPA presentation guidelines and the underlying assumptions provide a reasonable basis for the presentation.
• A warning (Caveat) that the prospective results may not be achieved.
• A statement that the accountant has no responsibility to update the report for events occurring after the report date.
• The manual or printed signature of the accountant or the accountant's firm.
• The accountant's city and state.
• The date of the report.
• For projections, a separate paragraph with an indication of the limitations on the usefulness of the presentation.
  o “The accompanying projection and this report are intended solely for the information and use of [identify specified parties, for example, XYZ Company and DEF National Bank], and are not intended to be and should not be used by anyone other than these specified parties.”
Independent Accountant's Report

To: Appropriate addressee

We have examined the accompanying forecast of XYZ Company, which comprises the forecasted balance sheet as of December 31, 20XX, and the related forecasted statements of income, retained earnings, and cash flows for the year then ended, based on the guidelines for the presentation of a forecast established by the American Institute of Certified Public Accountants. XYZ Company's management is responsible for preparing and presenting the forecast in accordance with the guidelines for the presentation of a forecast established by the American Institute of Certified Public Accountants. Our responsibility is to express an opinion on the forecast based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether the forecast is presented in accordance with the guidelines for the presentation of a forecast established by the American Institute of Certified Public Accountants, in all material respects. An examination involves performing procedures to obtain evidence about the forecast. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of the forecast, whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

In our opinion, the accompanying forecast is presented, in all material respects, in accordance with the guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions are reasonably supported and provide a reasonable basis for management's forecast.

There will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Jessica Daubson, CPA
Santa Ana, CA
March 1, 20XX

For agreed-upon procedures, the report must include the following:

- The findings of the accountant resulting from the procedures.
- A statement that the procedures applied may not be sufficient, and that the specified users accept responsibility for this fact.
- A warning (Caveat) that the prospective results may not be achieved.
- A statement that the accountant has no responsibility to update the report for events occurring after the report date.
A separate paragraph with an indication of the **limitations on the usefulness** of the presentation (remember that all agreed-upon procedures engagements result in limited use reports).

A summary of **significant assumptions** is also required.

### PROSPECTIVE FINANCIAL STATEMENTS

- **Forecast** (General Use) → Expects to occur
- **Projection** (Limited Use ⇒ Add a Middle ¶) → “Hypothetical” – May or may not occur; Can only give it to people directly negotiating with you
  1. **Examination** → Giving an Opinion
     a. Met AICPA minimum presentation guidelines
     b. F/S reasonable given assumptions
        - If not, called partial presentation (limited use)
  2. **Agreed-Upon Procedures**
     a. Only going to do procedures you told us to do
     b. Distribution & Use is Limited

- Included in both reports
  1. Results may NOT be achieved
  2. NO responsibility to update

### Compliance Attestation (AT-C 315)

AT-C 315 provides the aspects an accountant should consider with respect to attestation engagements related to an entity's compliance with specified laws, regulations, rules, contracts or grants, including reports on the effectiveness of internal controls over compliance with those requirements. There are two different types of engagements that are covered under AT-C 315:

- **Examination** – The accountant obtains reasonable assurance and expresses an opinion on (1) the entity's compliance with specified requirements of laws, regulations, rules, contracts, or grants; or (2) an assertion about compliance with such requirements.
  - Note that AT-C 315 does NOT apply to *examination engagements* with respect to internal control over compliance with specified requirements; such engagements are covered only under AT-C 105 and 205. AU-C 940, *An Audit of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*, can also be used for guidance.

- **Agreed-Upon Procedures** – The accountant applies tests that are the result of an agreement between the CPA, the client, and a third party with whom the client is negotiating. Such an engagement can only result in a report for **limited use** in which the accountant describes the procedures applied and the accountant's findings. The agreed-upon procedures may relate to (1) compliance with specified requirements as described above or (2) internal control over compliance with such requirements.

As previously mentioned, a review is not allowed for testing compliance with laws, rules, regulations, contracts, or grants. AT-C also does not apply to situations covered under AU-C 806, *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in*
Among the **requirements specific to an examination** of compliance with specified requirements, the accountant should:

- Determine that management (1) accepts responsibility for such compliance with specified requirements, including its internal control over compliance; and (2) evaluates the entity's compliance, which may include documentation, written policies, accounting manuals, etc.
- Request a **written assertion** from management. If management refuses, the accountant should withdraw from the engagement, if possible.
- Design the engagement to detect **material noncompliance**, whether intentional or not.
- Consider **materiality** with establishing the overall engagement strategy.
- **Obtain an understanding of specified requirements.** This should include obtaining an understanding of the applicable laws, rules, regulations, etc. as well as relevant knowledge obtained in previous engagements, and discussing such matters with appropriate personnel (e.g., internal auditors).
- Evaluate the following factors when the client has **multiple components** (e.g., locations, branches, etc.):
  - How the compliance requirements apply at each level of the organization
  - Materiality
  - Centralization of records
  - The control environment, including management's direct control over delegation of authority and its ability to supervise the various components
  - Nature and extent of operations at the various components
  - The similarities of operations over compliance for the various components
- **Obtain an understanding of relevant I/C over compliance** sufficient to plan the engagement and **assess control risk** for compliance with specified requirements.
- **Review any relevant reports and communications with regulatory agencies** and inquire of the regulatory agencies as to any current or ongoing examinations.
- **Obtain written representations** that (1) acknowledge management's responsibility for establishing and maintaining effective I/C over compliance, (2) provide that management has evaluated the entity's compliance with specified requirements, and (3) provide management's understanding of any compliance requirements subject to interpretation. Note that these are in addition to the representations required for examination engagements in general under AT-C 205, as previously discussed, and refusal to provide any written representation constitutes a scope limitation sufficient to preclude an unmodified opinion or cause the accountant to withdraw, if possible.
- Form an **opinion** based on the accountant's evaluation of (1) the nature and frequency of any noncompliance instances found and (2) whether such noncompliance is material in relation to the nature of the compliance requirements.
  - If there is material noncompliance, it should be described and the opinion should be modified.

With respect to an **agreed-upon procedures engagement** related to compliance with specified requirements or I/C over compliance, the accountant should:
• Determine that management (1) accepts responsibility for such compliance with specified requirements, including its internal control over compliance; and (2) evaluates the entity's compliance with specified requirements or I/C over compliance.
• **Obtain an understanding of specified requirements.** Same considerations as for an examination (see above).
• Obtain written representations that (1) acknowledge management's responsibility for establishing and maintaining effective I/C over compliance, (2) provide that management has evaluated the entity's compliance with specified requirements or I/C over compliance, as appropriate, (3) provide management's understanding of any compliance requirements subject to interpretation, and (4) provide that management has disclosed any known noncompliance occurring after the period covered by the accountant's report. Note that these are in addition to the representations required for agreed-upon procedures engagements in general under AT-C 215, as previously discussed.

Candidates could be asked to prepare this type of report on the CPA exam, starting with a report example, such as any of the three that follow.
Examination Report on Compliance—Unmodified Opinion

Independent Accountant's Report

To: Appropriate addressee

We have examined XYZ Company's compliance with [identify the specified requirements, for example, the requirements listed in Attachment 1] during the period January 1, 20X1, to December 31, 20X1. Management of XYZ Company is responsible for XYZ Company's compliance with the specified requirements. Our responsibility is to express an opinion on XYZ Company's compliance with the specified requirements based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether XYZ Company complied, in all material respects, with the specified requirements referenced above. An examination involves performing procedures to obtain evidence about whether XYZ Company complied with the specified requirements. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material noncompliance, whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Our examination does not provide a legal determination on XYZ Company's compliance with specified requirements.

In our opinion, XYZ Company complied, in all material respects, with [identify the specified requirements, for example, the requirements listed in Attachment 1] during the period January 1, 20X1 to December 31, 20X1.

Peter Wilson, CPA
Santa Ana, CA
March 1, 20XX
Agreed-Upon Procedures Report on Compliance

Independent Accountant’s Report on Applying
Agreed-Upon Procedures

To: Appropriate addressee

We have performed the procedures enumerated below, which were agreed to by [identify the specified parties, for example, the management and board of directors of XYZ Company], related to XYZ Company’s compliance with [identify the specified requirements, for example, the requirements listed in Attachment 1] during the period January 1, 20X1 to December 31, 20X1. XYZ Company’s management is responsible for its compliance with those requirements. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representations regarding the sufficiency of the procedures enumerated below either for the purpose for which this report has been requested or for any other purpose.

[Include paragraphs to enumerate procedures and findings.]

This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. We were not engaged to and did not conduct an examination or review, the objective of which would be the expression of an opinion or conclusion, respectively, on compliance with specified requirements. Accordingly, we do not express such an opinion or conclusion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of [identify the specified parties, for example, the management and board of directors of XYZ Company] and is not intended to be, and should not be, used by anyone other than the specified parties.

Ruiza Guillermo, CPA
Santa Ana, CA
March 1, 20XX
Agreed-Upon Procedures Report on I/C Over Compliance

Independent Accountant’s Report on Applying Agreed-Upon Procedures

To: Appropriate addressee

We have performed the procedures enumerated below, which were agreed to by [identify the specified parties, for example, the management and board of directors of XYZ Company], related to XYZ Company’s internal control over compliance with [identify the specified requirements for example, the requirements listed in Attachment 1], as of December 31, 20X1. XYZ Company’s management is responsible for its internal control over compliance with those requirements. The sufficiency of these procedures is solely the responsibility of the parties specified in this report. Consequently, we make no representations regarding the sufficiency of the procedures enumerated below either for the purpose for which this report has been requested or for any other purpose.

[Include paragraphs to enumerate procedures and findings.]

This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. We were not engaged to and did not conduct an examination or review, the objective of which would be the expression of an opinion or conclusion, respectively, on internal control over compliance with specified requirements. Accordingly, we do not express such an opinion or conclusion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of [identify the specified parties, for example, the management and board of directors of XYZ Company] and is not intended to be, and should not be, used by anyone other than the specified parties.

Zachary Armins, CPA
Santa Ana, CA
March 1, 20XX

Management’s Discussion and Analysis (MD&A) (AT-C 395)

Publicly held entities are required to provide a set of disclosures referred to as Management Discussion and Analysis (MD&A) in accordance with certain rules prescribed by the SEC. In addition, some nonpublic entities prepare MD&A and management asserts that it is presented in accordance with SEC requirements. A CPA may be engaged to perform either an examination or a review of MD&A for either type of entity.

- An examination would ordinarily be performed in conjunction with an audit of the F/S.
- A review may be performed for an annual period, an interim period, or a combination of an annual and an interim period.

Such an engagement may only be accepted if the most recent period covered by the MD&A was audited by the CPA and all other periods covered by the MD&A were audited by either the CPA or a predecessor.
As a result of the engagement, the CPA will issue either an examination report or a review report, as appropriate. Both reports address the same issues:

- Does the MD&A include all of the required elements?
  - An examination report will indicate that the presentation includes all required elements.
  - A review report will indicate that nothing came to the accountant’s attention to indicate that all required elements were not included.

- Was the historical financial information included in MD&A accurately derived from the F/S?
  - An examination report will indicate that the historical financial information was accurately derived from the F/S.
  - A review report will indicate that nothing came to the accountant’s attention to indicate that the historical financial information was not derived from the F/S.

- Do the underlying information, determinations, estimates, and assumptions provide a reasonable basis for the disclosures included in MD&A?
  - An examination report will indicate that the information, determinations, estimates, and assumptions provide a reasonable basis for the disclosures.
  - A review report will indicate that nothing came to the accountant’s attention that the information, determinations, estimates, and assumptions did not provide a reasonable basis for the disclosures.

**VARIOUS ENGAGEMENTS**

There are various other types of engagements that an accountant may perform that are each lightly tested on the exam.

1. A client may wish to present condensed financial statements or selected data in an advertisement, brochure, or other presentation which doesn’t include the basic F/S and notes. The accountant may issue a report on such information as long as they audited the basic F/S from which the condensed data is derived. The report on the condensed F/S must:
   - Refer to the audit, providing the report date and type of opinion expressed.
   - State whether the condensed data is fairly stated in all material respects in relation to the complete F/S.

2. An accountant may be asked to report on pro forma financial statements (AT-C 310) that are derived from historical F/S. This refers to a presentation in which information is restated for an event that actually hadn’t occurred. For example, a client that is considering a change in accounting principle might want to see how the F/S of the preceding year would have appeared had the change been made earlier. As long as the F/S from which the pro forma statements were derived were audited an examination engagement of this type is permitted. Similarly, as long as the F/S from which the pro forma statements were derived were audited or reviewed, a review engagement of this type may be performed.

Note: AT-C 310 covers examination and reviews of the information. Note: Agreed-upon procedures engagements are also allowed, but they are subject only to the applicable rules for agreed-upon procedures engagements under AT-C 215 as well as the common concepts under AT-C 105, not AT-C 310. Compilations of pro forma financial information are covered by SSARS, not SSAE; specifically, AR-C 120.
The examination (or review) report must:
  o Refer to the audit (or review), providing the report date and type of opinion (or conclusion) expressed.
  o Provide **reasonable assurance** (or limited if a review) as to the assumptions and presentation of the pro forma data being reasonable. Should also obtain a management representation letter.

SSARS 22 expands the applicability of the SSARS to apply when the CPA is engaged to compile or issue a **compilation report** on *pro forma* financial information. The CPA’s compilation or review report, or the auditor’s report on the historical F/S, should be included (or incorporated by reference) in the document containing the *pro forma* financial information. No management representation letter is required.
Independent Accountant’s Report

We have examined the pro forma adjustments giving effect to the underlying transaction (or event) described in Note 1 and the application of those adjustments to the historical amounts in the accompanying pro forma condensed balance sheet of X Company as of December 31, 20X1, and the related pro forma condensed statement of income for the year then ended (pro forma financial information), based on the criteria in Note 1. The historical condensed financial statements are derived from the historical financial statements of X Company, which were audited by us, and of Y Company, which were audited by other accountants, appearing elsewhere herein [or “and are readily available”]. The pro forma adjustments are based on management’s assumptions described in Note 1. X Company’s management is responsible for the pro forma financial information. Our responsibility is to express an opinion on the pro forma financial information based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether, based on the criteria in Note 1, management’s assumptions provide a reasonable basis for presenting the significant effects directly attributable to the underlying transaction (or event), and, in all material respects, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma amounts reflect the proper application of those adjustments to the historical financial statement amounts. An examination involves performing procedures to obtain evidence about management’s assumptions, the related pro forma adjustments, and the pro forma amounts in the pro forma condensed balance sheet of X Company as of December 31, 20X1, and the related pro forma condensed statement of income for the year then ended. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of the pro forma financial information, whether due to fraud or error. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

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 underlying transaction (or event) occurred at an earlier date. However, the pro forma condensed financial statements are not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above-mentioned transaction (or event) actually occurred at such earlier date.

In our opinion, based on the criteria in Note 1, management’s assumptions provide a reasonable basis for presenting the significant effects directly attributable to the above-mentioned transaction (or event) described in Note 1, and, in all material respects, the related pro forma adjustments give appropriate effect to those assumptions, and the pro forma amounts reflect the proper application of those adjustments to the historical financial statement amounts in the pro forma condensed balance sheet of X Company as of December 31, 20X1, and the related pro forma condensed statement of income for the year then ended.

***

3. An accountant may be auditing a U.S. entity which requires F/S that are in conformity with the accounting principles of another country and are intended for use outside the
U.S. This might be as part of an attempt to raise capital in the other country or because the U.S. entity is a subsidiary to be consolidated with a parent of the other country. SAS 124 (AU-C 910) requires the auditor to obtain an understanding of the purpose of the F/S, whether the reporting framework applied provides fair presentation of the F/S, the intended users of the F/S, and the steps taken by management to determine whether the reporting framework is acceptable. The audit will still conform to GAAS, but the report must indicate conformity with the principles of the other country and be presented in either of the following ways.

- A U.S.-style report modified to express an opinion on conformity with the principles of the other country (essentially comparable to a special report on OCBOA statements) with an explanatory paragraph “emphasizing a matter.”
- A report in which the form and content is consistent with that of the other country if such a report would be issued by auditors in the other country in similar circumstances; the auditor understands and has obtained sufficient appropriate audit evidence to support the report; and the auditor has complied with the other country's reporting standards and identifies the other country in the report. Issuing such a report may require the auditor to:
  - Report on statutory compliance or otherwise understand the local laws and regulations.
  - Obtain an understanding of applicable legal responsibilities, in addition to the auditing standards and the financial reporting framework generally accepted in the other country.

In instances where a report that is to be used in the United States was prepared in accordance with a financial reporting framework generally accepted in another country, the auditor is required to include an emphasis-of-matter paragraph to highlight the foreign financial reporting framework, but permits the auditor to express an unqualified opinion. This paragraph would follow the opinion paragraph.

4. An underwriter preparing a prospectus in connection with a public offering of securities under the Securities Act of 1933 will often ask the auditor for a letter that provides various levels of assurance on the information the underwriter must provide to the SEC. These letters are known as letter to underwriters or comfort letters (AU-C 920).

In this letter, the accountant may express an opinion on whether audited F/S conform to all of the SEC requirements for these statements. Since the filing information is derived from audited F/S, this type of engagement is similar to the reporting on condensed data or pro forma information.

However, the underwriter must include in the SEC filing certain capsule financial information about the company for the period after the balance sheet date of the last audit. Since the accountant has not audited this information, no opinion can be expressed on it. Instead, the accountant and underwriter will determine agreed-upon procedures for the CPA to perform, and the accountant will then provide negative assurance, stating that "nothing came to our attention" indicating a need to change the unaudited information. Notice that the wording of negative assurance is different from every other engagement discussed in this course, and is not permitted for other examinations, reviews, or agreed-upon procedure engagements in the absence of specific authority in
auditing pronouncements. The auditor is also required to inform the party requesting the comfort letter that the auditor cannot provide any assurance that the agreed-upon procedures are sufficient for that party's purposes.

The accountant must, of course, be independent (since both audits and agreed-upon procedures engagements result in written conclusions by the CPA), and will state so in the comfort letter.

When the auditor is a group auditor, the auditor is required to read the comfort letters of all component auditors whose reports are included in the securities offering. This applies to all component auditors and is not limited to those auditors of significant components.

An accountant is not required by standards to accept an engagement to issue a comfort letter. In addition, if such an engagement is accepted, the accountant is not required to provide assurance relative to all matters for which assurance is requested.

The letter to the underwriter is provided by the accountant to the underwriter (or dealer, broker or client), and this report is not considered to be a part of the registration statement filed by the underwriter with the SEC. If the underwriter makes any reference to the accountant's report, it is important that the CPA not be referred to as an "auditor" except in connection with information that was audited. A term such as "expert in accounting and auditing" might be a reasonable alternative.

When audited F/S of a nonissuer are included in a registration statement, AU-C 925 provides that it is the predecessor auditor's responsibility when the F/S they have audited are being included in an SEC registration statement filing to:
  o Read pertinent portions of the document.
  o Perform subsequent events procedures.
  o Obtain a letter of representation from the successor auditor.

Lecture 8.05

CLASS QUESTIONS

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.
CLASS QUESTIONS

Work through the below Class Questions while following along with the respective lectures. Once this is complete, you can begin independently practicing what you've learned by quizzing yourself on this course section in your Interactive Practice Questions (IPQ), which can be found in your online Student Dashboard. Your IPQ simulates the computer-based testing experience, and will also help you understand how concepts are applied to the exam. Each question includes answer explanations from expert CPAs that will help you determine why you answered a question correctly or incorrectly. This is key to your success on the CPA Exam.

Lecture 8.05

1. When an auditor reports on financial statements prepared on an entity's income tax basis, the auditor's report should
   a. Disclaim an opinion on whether the statements were examined in accordance with generally accepted auditing standards.
   b. Not express an opinion on whether the statements are presented in conformity with the comprehensive basis of accounting used.
   c. Include an explanation of how the results of operations differ from the cash receipts and disbursements basis of accounting.
   d. State that the basis of accounting is described in a footnote in the Financial Statements.

2. Helpful Co., a nonprofit entity, prepared its financial statements on an accounting basis prescribed by a regulatory agency solely for filing with that agency. Green audited the financial statements in accordance with generally accepted auditing standards and concluded that the financial statements were fairly presented on the prescribed basis. Green should issue a
   a. Qualified opinion.
   b. Standard three-paragraph report with reference to footnote disclosure.
   c. Disclaimer of opinion.
   d. Special purpose report.

3. The client's financial reporting includes supplementary financial information outside the basic financial statements but required by the Financial Accounting Standards Board (FASB). Which of the following statements is correct regarding the auditor’s responsibility for this supplementary financial information?
   a. The auditor should perform limited procedures.
   b. The auditor should apply tests of details of transactions.
   c. The auditor is not required to report omissions.
   d. The auditor should read the supplementary financial information.

4. When an accountant issues to an underwriter a comfort letter containing comments on data that have not been audited, the underwriter most likely will receive
   a. Negative assurance on capsule information.
   b. Positive assurance on supplementary disclosures.
   c. A limited opinion on pro forma financial statements.
   d. A disclaimer on prospective financial statements.
5. A practitioner has examined a client's compliance with debt covenants associated with a bank loan and is ready to issue a report. Which of the following standards apply to the report?
   a. Internal control standards.
   b. Compliance attestation standards.
   c. Agreed-upon procedures standards.
   d. Auditing standards of field work.

6. Accepting an engagement to examine an entity's financial projection most likely would be appropriate if the projection were to be distributed to
   a. All employees who work for the entity.
   b. Potential stockholders who request a prospectus or a registration statement.
   c. A bank with which the entity is negotiating for a loan.
   d. All stockholders of record as of the report date.

7. Which of the following is a prospective financial statement for general use upon which an accountant may appropriately report?
   a. Financial projection.
   b. Partial presentation.
   c. Pro forma financial statement.
   d. Financial forecast.

8. In which of the following engagements would a practitioner provide limited assurance about the possible significant effects on the historical financial statements if a change in capitalization had occurred at an earlier date?
   a. A compilation of a financial projection.
   b. A review of pro forma financial information.
   c. An examination of management's discussion and analysis.
   d. An audit of condensed interim financial information.

Lecture 8.07

9. Hill, CPA, is auditing the financial statements of Helping Hand, a not-for-profit organization that receives financial assistance from governmental agencies. To detect misstatements in Helping Hand's financial statements resulting from violations of laws and regulations, Hill should focus on violations that
   a. Could result in criminal prosecution against the organization.
   b. Involve significant deficiencies to be communicated to the organization's trustees and the funding agencies.
   c. Have a direct and material effect on the amounts in the organization's financial statements.
   d. Demonstrate the existence of material weaknesses.
10. When auditing an entity’s financial statements in accordance with Government Auditing Standards (the “yellow book”), an auditor is required to report on

I. Noteworthy accomplishments of the program.
II. The scope of the auditor’s testing of internal controls.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

11. When auditing an entity’s financial statements in accordance with Government Auditing Standards (the “yellow book”), an auditor is required to report on

I. Recommendations for actions to improve operations.
II. The scope of the auditor’s tests of compliance with laws and regulations.
   a. I only.
   b. II only.
   c. Both I and II.
   d. Neither I nor II.

12. In performing a financial statement audit in accordance with Government Auditing Standards, an auditor is required to report on the entity’s compliance with laws and regulations. This report should
   a. State that compliance with laws and regulations is the responsibility of the entity’s management.
   b. Describe the laws and regulations that the entity must comply with.
   c. Provide an opinion on overall compliance with laws and regulations.
   d. Indicate that the auditor does not possess legal skills and cannot make legal judgments.

13. In reporting under Government Auditing Standards, an auditor most likely would be required to communicate management’s misappropriation of assets directly to a federal inspector general when the fraudulent activities are
   a. Concealed by management by circumventing specific internal controls designed to safeguard those assets.
   b. Reported to the entity’s governing body and the governing body fails to make a required report to the federal inspector general.
   c. Accompanied by fraudulent financial reporting that results in material misstatements of asset balances.
   d. Perpetrated by several levels of management in a scheme that is likely to continue in future years.
14. Wolf is auditing an entity’s compliance with requirements governing a major federal financial assistance program in accordance with Government Auditing Standards. Wolf detected noncompliance with requirements that have a material effect on the program. Wolf’s report on compliance should express
   a. No assurance on the compliance tests.
   b. Reasonable assurance on the compliance tests.
   c. A qualified or adverse opinion.
   d. An adverse or disclaimer of opinion.
CLASS SOLUTIONS

1. **(d)** An auditor may accept an engagement to express an opinion on financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP, referred to as a special purpose framework. If there are no scope limitations, the auditor will express an opinion and a disclaimer is not required (a). The opinion will indicate whether the financial statements were presented fairly in conformity with the comprehensive basis of accounting under which they were prepared (b). The entity will provide an explanation of how the comprehensive basis of accounting differs from GAAP, not the auditor, although the auditor will generally refer to the entity’s footnote in an emphasis-of-a-matter paragraph (c). The auditor will state that the basis of accounting is described in a footnote to the financial statements.

2. **(d)** A regulatory basis of accounting is considered a special purpose framework. An auditor may accept an engagement to report on financial statements prepared in accordance with a special purpose framework, and will issue a disclaimer if there is a scope limitation preventing the auditor from obtaining sufficient appropriate audit evidence (c), or a qualified opinion if there is either a departure from the framework or an uncertainty that the auditor was unable to resolve (a). The auditor may not use the standard report (b) but will instead issue a special report that is appropriate for the circumstances.

3. **(a)** An auditor’s opinion on financial statements does not apply to required supplementary information. Since it is required, however, omission would constitute a departure from the applicable financial reporting framework, which is required to be addressed in the auditor’s report. As a result, the auditor will apply limited procedures to required supplementary information, consisting of making inquiries of management; comparing the information to management’s responses to the inquiries, the financial statements, and other knowledge obtained by the auditor, which would generally require the reading of the required supplementary information. These procedures are designed to enable the auditor to meet the requirement to describe in the auditor’s report whether the required supplementary information is presented and to communicate when some or all of it has not been presented, when it is not presented in accordance with guidelines, or if it requires material modification. The auditor is not required to perform tests of details of the transaction. Although the auditor will most likely need to read the required supplementary information to achieve the reporting objectives, there is no specific requirement to do so other than performing a comparison. Note, however, the auditor’s responsibility with respect to other information (i.e., unaudited, voluntary information included in the document with audited F/S) is generally limited to reading the information for material inconsistencies.

4. **(a)** Accountants may be asked to issue letters to underwriters, also referred to as comfort letters. The subjects that may be covered in a comfort letter include: the independence of the accountant, an opinion as to whether the audited financial statements and schedules included in the registration statement comply with the requirements of the 1933 act, negative assurance on unaudited interim financial and capsule information, and negative assurance as to whether certain non-financial statement information included in the registration statement complies as to form in all material respects with Regulation S-K. When financial information has not been subjected to audit procedures, the auditor may not provide either positive assurance (b) or a limited opinion (c). An accountant’s association with prospective financial statements (d) is not a component of a comfort letter.
5. **(b)** Attestation standards apply to examinations, other than audits, which are subject to Statements on Auditing Standards; reviews, other than reviews of financial statements and other historical financial information, which are subject to Statements on Auditing Standards for Accounting and Review Services; and agreed-upon procedures engagements. An examination to determine if a client is in compliance with debt covenants is not an examination of financial statements subject to SAS and is, therefore, subject to the attestation standards. Internal control standards, to the extent that they exist, are directed toward the development of internal controls, not an examination of the client's compliance with debt covenants. Agreed-upon procedures standards are part of the attestation standards and apply only to engagements in which the practitioner is only applying those procedures the specified parties agree to have the auditor perform. Auditing standards apply to audits of financial statements, not examinations of compliance with debt covenants.

6. **(c)** Financial projections are based on hypothetical assumptions, creating the danger that someone who is not familiar with those assumptions may draw invalid conclusions as to the meaning and reliability of the projections. As a result, reports on projected financial information are limited to individuals who are familiar with the matters and the hypothetical assumptions, such as a bank involved in negotiations with the entity. General groups, including employee groups (a), potential stockholders (b), or existing stockholders (d) who do not have certain qualifications would not be likely recipients.

7. **(d)** A financial forecast is a prospective financial statement that is based on the past performance of the entity and is appropriate for general use. A financial projection, on the other hand, involves certain assumptions, projecting the possible outcome of certain future transactions or events. As a result, a report on a projection should be limited to those with an understanding of the transactions or events (b). Similarly, a pro forma financial statement represents a restatement of historical information, showing the possible effects that might have occurred if a transaction or event that may or may not have actually occurred had occurred earlier. Users should also be limited to those with an understanding (c). A partial presentation, by its nature, does not provide all of the information that is considered necessary under GAAP and should be limited to those who understand the deficiencies (b).

8. **(b)** Limited assurance is only provided in a review. No assurance is provided in a compilation and an opinion is expressed in an examination or an audit. Pro forma financial statements are historical financial statements that are adjusted to reflect management's estimate of the effects that would have been incurred if an event or transaction had occurred during or before the fiscal period being reported on.

9. **(c)** To detect misstatements in the financial statements, the auditor will look for violations that have a financial statement implication. An auditor is not an attorney and will not necessarily know what violations would result in criminal prosecution (a). An auditor does not perform procedures to seek deficiencies that are required to be communicated (b) or material weaknesses (d), but communicates those that are detected during the course of the engagement.

10. **(b)** While an entity's management may wish to boast of noteworthy accomplishments, the auditor reports on those matters that are the subject of the audit, including the scope of the auditor's testing of internal control.
11. (b) An auditor may or may not find areas where the auditor can make recommendations to improve operations, which is beyond the scope of what an audit addresses anyway. An auditor does test compliance with laws and regulations, particularly those that have the potential of materially affecting information in the financial statements.

12. (a) Compliance with laws and regulations is the responsibility of management and the auditor’s report so indicates. The auditor will not necessarily be familiar with all laws and regulations the entity must comply with and such a description will not be included in the report (b). The auditor only addresses those laws and regulations that have a potential material effect on the financial statements and cannot express an opinion on overall compliance (c). Since becoming an auditor does not require an in-depth knowledge of the law, there is no need to indicate that the auditor does not possess such knowledge and skills (d).

13. (b) In general, an auditor will limit communication about fraud to those within the entity at a level of management or governance that is above that at which the fraud was committed. The fact that the fraud was concealed by circumventing controls (a), involved fraudulent financial reporting (c), or involved several levels of management (d) would not change the auditor’s reporting responsibilities. If the governing body, however, fails to meet its obligations to report the matter to the federal inspector general, the auditor will be required to do so.

14. (c) When engaged to audit an entity’s compliance with requirements governing a major federal financial assistance program, identification of incidents of noncompliance are comparable to identification of departures from GAAP in an audit of an entity’s compliance with GAAP. Depending on the severity of the noncompliance, the auditor will issue either a qualified opinion, if material but not necessarily pervasive, or an adverse opinion if pervasive as well. An auditor cannot avoid disclosure by providing no assurance (a), and reasonable assurance (b) would only be appropriate if there were no significant incidents of noncompliance. A disclaimer of opinion (d) would only be appropriate if the auditor was unable to obtain sufficient appropriate audit evidence to develop an opinion.
Starting on Page 9-1, the following replaces all of Section 9, much of which has been revised and reorganized.

Lecture 9.01
ENVIRONMENT & GENERAL CONTROLS
Characteristics of an IT Environment

Although the existence of an electronic system does not change the basic objectives of an audit engagement, it has a major impact on the approach used to achieve those objectives.

The responsibility for determining the acceptable level of audit risk and assessing the component risks remains with the auditor. Computer software cannot replace the judgment of the auditor. The auditor cannot give an opinion on the effectiveness of Internal Control if the “auditing around the computer” approach is used.

The use of IT affects the initiation, authorization, recording, processing, and reporting of transactions, and may affect any of the five components of internal control (CRIME). Virtually every accounting system has, by now, incorporated computers to a great extent, and the area of Information Technology (IT) has, in response, become a more important subject on the CPA exam. With IT also tested in the BEC exam section, AUD exam section questions tend to focus on the CPA's examination and use of the client's IT system.

- **Benefits of IT**
  - Consistency – Computers process data the same way every time.
  - Timeliness – Electronic processing and updating is normally more efficient.
  - Analysis – Data can be accessed for analytical procedures more conveniently (with proper software).
  - Monitoring – Electronic controls can be monitored by the computer system itself.
  - Circumvention – Controls are difficult to circumvent when programmed properly, and exceptions are unlikely to be permitted.
  - Segregation of Duties – Enhanced segregation of duties through effective implementation of security controls.

- **Risks of IT**
  - Overreliance – Without clear output, IT systems are often assumed to be working when they are not.
  - Access – Destruction, and alteration of large amounts of data without detection are possible if unauthorized access occurs—aside from the potential unauthorized use of confidential information.
  - Changes in programs – Severe consequences without detection are possible if unauthorized program changes occur.
  - Failure to change – Programs are sometimes not updated for new laws, rules, or activities.
  - Manual intervention – Knowledgeable individuals can sometimes alter files by bypassing the appropriate programs.
  - Loss of data – Catastrophic data loss is possible if appropriate controls aren't in place.

The auditor should obtain audit evidence about the accuracy and completeness of information produced by the entity's information system when that information is used in performing audit
procedures. The primary advantage of IT as it relates to an audit is that a computer is not as subject to random errors as a human. As a result, an auditor who is able to verify that a computer program is working properly will not have to test individual transactions to be sure the computer is following directions consistently because it will always follow its program. An audit of a computerized system can, therefore, rely more heavily on internal control structure and reduce the need for substantive testing, making the audit potentially more efficient.

There are two risks of major concern to the auditor:

- Unauthorized access to a computer system can cause more damage to the accounting system as a whole than in a manual system where it is difficult for one person to access, change, or destroy all the different records of the system.
- The audit trail is an electronically visible trail of evidence enabling one to trace information contained in statements or reports back to the original input source. An audit trail is also important to the client for the proper functioning of the system during the year, since such a trail allows monitoring of activities, providing a deterrent to fraud and making it possible to answer queries by examining the source data. This would require the auditor to establish the reliability and extent of the audit trail.

The processing of transactions can take place in one of two general ways:

- Online Transaction Processing (OLTP)
- Batch processing

OLTP means that the database is updated as soon as a transaction is received (Immediately). Transaction processing keeps business records up-to-date the moment transactions are keyed or transmitted into a system. This produces records that are as current as possible, but poses a problem of requiring that computers be continually running and accessible at all points-of-transaction.

Batch processing involves gathering information and then entering transactions in a group to the computer periodically. This allows for greater control over the input process, including more possibility for verifying data entry with control totals and authorization before input. The major difficulty is associated with the delay between the transactions and the input, which can result in accounting records not accurately reflecting the current situation.

As an example of the choice between the two approaches, a bank is going to use OLRT for the processing of cash withdrawals, since it is critical that these be immediately reflected in the customer's balance, and errors can be easily reversed later with little harm to the bank. On the other hand, it probably will use batch processing for payroll, enabling it to be processed efficiently. Since, in most business environments, employees are paid on designated dates, either all on the same date or in groups, it is more efficient to report all the payroll transactions occurring on the same date with a single entry summarizing all the payments.

Different computers will often communicate with each other, and a link of different computers is known as a network. The sharing of data within a company among its various computers is known as an intranet due to the fact that only computers within the same company can communicate with each other in such a system. The linking of computers may be done in different ways using different Network configurations:

- Local area networks (LANs) - Communication network that serves several users within a specified geographical area. A personal computer LAN functions as distributed processing system in which each computer in the network does its own processing and manages
some of the data. Shared data are stored in a file server that acts as a remote disk drive for all users in the network.

- **Value-added network (VAN)** – Links different companies’ computer files together.
- **Wide area networks (WANs)** - A computer network connecting different remote locations that may range from short distances, such as a floor or building, to extremely long transmissions that encompass a large region or several countries.

The need for solid physical transmission media in local area networks (LANs) has been overcome through the development of **wireless local area networks (WLANs)**. Short-range radio transmission allows different computers to communicate with each other and share printers, Internet connections, and other devices. The two prominent standards for WLANs are **Wi-Fi** (also known as 802.11) and **Bluetooth**. Any devices that are in the same vicinity that follow the same standard can communicate. In addition to computers, cell phones and personal digital assistants (PDAs) are often equipped to use one or both standards. Clearly, unauthorized access is a major danger with WLANs, and both encryption of data and passwords to connect to the system are critical security needs to prevent others with wireless devices from accessing the system. On the other side, many businesses, such as hotels and restaurants, have Wi-Fi connections for the benefit of guests and patrons to allow them high-speed Internet access (sometimes requiring logging into a network at a fee and sometimes at no charge to encourage visitors). Employees using these networks (while traveling, for instance) could put their employers at additional risk of unauthorized access.

### Electronic commerce

Electronic commerce (e-commerce) is one of the most popular electronic business (e-business) implementations. It is the buying and selling of goods online, usually via the internet. Typically, a website will advertise goods and services, and the buyer will fill in a form on the website to select the items to be purchased and provide delivery and payment details or banking services such as transfers and payment orders. The website may gather details about customers and offer other items that may be of interest. The cost of a brick-and-mortar (physical store location) is avoided and the savings are often a benefit to the customers, sometimes leading to spectacular growth. The term e-business includes buying and selling online as well as other aspects of online business such as customer support relationships between businesses.

E-commerce, as a general model, uses technology to enhance the processes of commercial transactions among a company, its customers and business partners. The used technology can include the Internet, multimedia, web browsers, proprietary networks, ATMs, and home banking, and the traditional approach to Electronic Data Interchange (EDI). However, the primary area of growth in e-commerce is through the use of the Internet as an enabling technology.

Some communication of company computers with outside computers belonging to suppliers, customers, and other correspondents (trading partners) requires the use of **Electronic Data Interchange (EDI)**. The worldwide linking that currently allows almost any computer in the world to participate is known as the **Internet**, but more restricted systems can be created that will be strictly limited to the company and known outsiders such as customers. These are known as **extranets**. An EDI system requires communications software, translation software and access to standards. Communications software moves data from one point to another, flags the start and end of an EDI transmission, and determines how acknowledgments are transmitted and reconciled. Translation software helps build a map and shows how the data fields from the application correspond to elements of an EDI standard. Later, it uses this map to convert data back
and forth between the application and EDI formats. There are several special considerations related to EDI:

- **Strict standards** are needed for the form of data so that it will be understood by the computers at both ends. An example is the use of the ASCII format for text data.
- **Translation software** is needed by each computer so that it can convert data between the standard used for EDI and the form needed for processing internally. An example is the use of browser programs to access websites.
- **Unauthorized access** to company computers and interception of transmissions are much greater dangers, requiring the use of encryption (application control) programs that make stolen data unreadable to someone without knowledge of the coding method and firewall programs that prevent access to the network without the explicit permission originating from the company computer.

A **virus** is a program with the ability to reproduce by modifying other programs to include a copy of itself. A virus may contain destructive code that can move into multiple programs, data files or devices on a system and spread through multiple systems in a network. A **Trojan horse** is purposefully hidden malicious or damaging code within an authorized computer program. Unlike viruses, they do not replicate themselves, but they can be just as destructive to a single computer. A **worm** is a program that duplicates itself over a network so as to infect many computers with viruses. A **hoax virus** is a widely distributed e-mail message warning of a virus that doesn't exist. A **killer application** simply refers to a program that is extremely useful, and is not dangerous. **Phishing** (brand spoofing or carding) is the act of sending an e-mail to a user falsely claiming to be an established legitimate enterprise in an attempt to scam the user into surrendering private information that will be used for identity theft. Various types of software have been developed to protect computers against these types of invasive problems. **Antivirus software**, for example, is used to protect software against viruses that may destroy or erase it.

A tool for establishing security is a **firewall**, which prevents unauthorized users from accessing data. A firewall can be in the form of a computer program (software) or a physical device that blocks the transmission media being used (hardware). A **network firewall** is designed to prevent unauthorized access to the company computers, while **application firewalls** protect individual programs. Network firewalls are easier and cheaper to implement, but if penetrated, leave the computers at severe risk. Application firewalls need to be installed for each individual program the company wishes to protect, but allow additional user authentication procedures to protect the program and data and make access more difficult.
GENERAL CONTROLS

Since the auditor will usually want to rely heavily on the internal control structure of a computer-based accounting system, gaining an understanding of the internal control structure is crucial. Initially, the focus of the auditor will be on understanding the general controls that relate to the overall integrity of the system. Later, the auditor may examine application controls that relate to the performance of individual computer programs. If the general controls are poor, it is unlikely that the application controls will be effective, no matter how strong they are.

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<tr>
<th>General Controls – Overall Environment</th>
<th>Application Controls – Program Controls</th>
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<tr>
<td>Overall Computer Environment</td>
<td>Specific Program Controls</td>
</tr>
<tr>
<td>1) Personnel Policies</td>
<td>1) Input</td>
</tr>
<tr>
<td>- Systems = Development &amp;</td>
<td>- Check Digit → Input correctly</td>
</tr>
<tr>
<td>Maintenance (analysts,</td>
<td>- Validity Check (Valid SS#)</td>
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<td>application programmer,</td>
<td>- Edit Test → #s in SS not letters</td>
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<tr>
<td>database administrator)</td>
<td>- Limit Test → SSs not greater than</td>
</tr>
<tr>
<td>- Operations = Input (data entry →</td>
<td>9 characters</td>
</tr>
<tr>
<td>make sure computer operator is</td>
<td>- Financial total</td>
</tr>
<tr>
<td>screened and receives ethics</td>
<td>- Record counts</td>
</tr>
<tr>
<td>training) = Output (control clerk</td>
<td>- Hash = A meaningless total</td>
</tr>
<tr>
<td>or librarian)</td>
<td>- Non-financial totals</td>
</tr>
<tr>
<td></td>
<td>- Digital signature (authorization)</td>
</tr>
<tr>
<td>2) File Security</td>
<td>2) Processing</td>
</tr>
<tr>
<td>- Back Up – Grandfather/father/son</td>
<td>- System &amp; software documentation</td>
</tr>
<tr>
<td>retention system</td>
<td>- Error-checking compiler</td>
</tr>
<tr>
<td>- Lock Out</td>
<td>- Test data</td>
</tr>
<tr>
<td>- Read-Only</td>
<td>- System testing</td>
</tr>
<tr>
<td>3) Business Continuity Planning –</td>
<td>3) Output – Accurate</td>
</tr>
<tr>
<td>Business Interruption – identify</td>
<td></td>
</tr>
<tr>
<td>the business processes of</td>
<td></td>
</tr>
<tr>
<td>strategic importance</td>
<td></td>
</tr>
<tr>
<td>– Disaster Recovery (hot/cold site)</td>
<td></td>
</tr>
<tr>
<td>- Hot Site (Computer’s are ready</td>
<td>- Distribution lists</td>
</tr>
<tr>
<td>to go)</td>
<td>- Shredders</td>
</tr>
<tr>
<td>- Cold Site (No computer waiting)</td>
<td>- System testing</td>
</tr>
<tr>
<td>4) Computer Facilities – Fire/Insurance</td>
<td></td>
</tr>
<tr>
<td>5) Access Controls</td>
<td></td>
</tr>
</tbody>
</table>
• **Authorization** – The development of new programs and changes to existing programs should be performed by **systems analysts** and **programmers**. These personnel should not be involved in the supervision of computer operations or the control and review of output.

• **Recording** – **Data input clerks** and **computer operators** have the role of entering information into the computer and running the programs. These personnel should not have access to program code that would enable them to modify programs nor should they control the output.

• **Custody** – **Control clerks** and **librarians** obtain and review the output from computers to review exception reports indicating inappropriate functioning of the computer, send printouts and other output to the appropriate destinations, and maintain disks, tapes, or other storage units of data. These personnel should not have the ability to create or alter programs or to operate the computers that generate the information.

Clearly, general controls over **access** to computers and files are of great significance in evaluating internal control in an IT environment. This is particularly important in networks, since the data is distributed widely in such cases. Access to programs and data should require the entry of **passwords** or identification numbers, and different levels of password authority should apply so that employees only gain access to the programs and files that are compatible with their assigned responsibilities. An auditor can test these procedures by entering invalid passwords to see that they are rejected and verifying that valid passwords only provide compatible access.

- Passwords should be changed regularly to make unauthorized access more difficult.
- Protocols for passwords should encourage the use of random letters, numbers, and symbols, making it more difficult for someone to break through a firewall.

**Business Continuity Planning**
The purpose of business continuity/disaster recovery is to enable a business to continue offering critical services in the event of a disruption and to survive a disastrous interruption to activities. This includes:

• **Identify the business processes of strategic importance** – Those key processes that are responsible for both the permanent growth of the business and for the fulfillment of the business goals. Based on the key processes, the risk management process should begin with a risk assessment. The risk is directly proportional to the impact on the organization and the probability of occurrence of the perceived threat.

• **Backup controls** – Copies of files and programs should be maintained to allow reconstruction of destroyed or altered files. This may include copies on the same computer, backups to removable storage media, such as disks, and off-premises backups to computers and locations outside the company. Copies may be identical or the client may use the **grandfather-father-son** retention system in which periodic saving of data versions allows the reconstruction of records by starting with an older file and reentering lost data since that time (the name comes from the general idea of saving at least two generations of older data so that, if the immediate version before the lost file is also lost, reconstruction can start two versions back with reentry of all data processed since that point).

• **Planned downtime controls** – Since some downtime is inevitable, planned downtime allows maintenance so that unplanned downtime doesn't interrupt system operations.

• **Checkpoint** – Similar to grandfather-father-son, but at certain points, “checkpoints,” the system makes a copy of the database and this “checkpoint” file is stored on a separate disk or tape. If a problem occurs, the system is restarted at the last checkpoint.
• **Disaster recovery** - The Company should have plans in place that will allow operations to be restored and continued in the event of physical destruction or disabling of the site of computer operations. This can be done by maintaining an alternate **hot site**, which has available computers and data ready to begin operations immediately in the event of the disaster, or a **cold site**, which has available space for operations but will require setup of computers and loading of data before operations can begin at that site.

**Documentation** of new programs and alterations to existing programs ensures that IT personnel are aware of the availability and proper use of programs and that changes in programming personnel during projects does not interfere with the ability of other employees to understand what has been done previously. This also may assist the auditor in learning about the system.

**Hardware controls** are built into computers by the manufacturer. Since computers do not actually think and visualize, but are simply electronic machines, the storage of data is in the form of switches. The term **binary** refers to the fact that the switches have only two possible positions. Binary computers can only think in terms of **bits** (binary digits) of information that are **on or off** ("1" or "0"). A series of 8 consecutive bits will produce a **byte** of information that represents a unit of human thought such as a letter, number, or other character. The manner in which data is described includes the following terms:

- **Character** – A letter, number, punctuation mark, or special character
- **Alphanumeric** – A character that is either a letter or number
- **Field** – an individual data element in a computer record. (such as a phone number or a city name)
- **Record** – A collection of related information treated as a unit. Separate fields within the record are used for processing the information. (Such as the name, address, and telephone of one employee).
- **File** – A group of logically related records (such as the contact info for all the employees)
- **Database** – A stored collection of related data needed by organizations and individuals to meet their information processing and retrieval requirements. (such as a payroll database that might have a file for contact info, a file with rate and withholding information, a file indicating hours worked, etc.).

Hardware controls may include:

- **Parity check** – In the storage of bytes, one bit will be a "dummy" bit that doesn't represent any actual information, but is turned on automatically when necessary so that the total number of bits in the on position is an odd number (in an odd-parity computer). When the computer is reading bytes of data from a chip or disk drive, a byte with an even number of bits turned on will be known to be functioning improperly.
- **Echo check** – When data is being transmitted from one computer to another, especially over telephone lines, distortions caused by static or other causes can cause information to be transmitted improperly. An echo check involves the data sent from one computer to another being transmitted back to the original one, which will verify that it has received what it sent. If the echoed data doesn't agree with the transmission, the packet of data is resent.
- **Virus protection software** – McAfee antivirus software, for example.
APPLICATION CONTROLS

The policies, procedures and activities designed to provide reasonable assurance that objectives relevant to a given automated solution (application) are achieved. They are designed to ensure that an individual computer application program performs properly, accepting authorized input, processing it correctly, and generating appropriate output. Many of the controls discussed on the exam involve verifying data that has been input to ensure the program doesn't accept inappropriate information. These include:

- **Field checks** – Data is validated as to the correct length and format. For example, an entry of a license plate might be verified for type (alphabetic, so that only letters and numbers are acceptable) and length (not longer than 7).

- **Validity checks** – Data is compared with a list of acceptable entries to be sure it matches one of them. For example, a field to accept the two-letter state abbreviation will be checked against a file that lists all the acceptable choices, so that an entry of OG for the state will be rejected as invalid.

- **Limit tests** – Numbers are compared to limits that have been set for acceptability. For example, the entry of a pay rate may be compared to the current minimum wage on the lower side and $50 per hour on the upper side to be sure the number entered makes sense. This is sometimes called a reasonableness test, and is the closest computer equivalent to human judgment in reviewing information.

- **Check digits** – Numbers with no obvious meaning, such as identification numbers, are often designed so that one of the digits is determined by a formula applied to the rest of the number. The computer applies the formula when a number is entered to determine if it is an acceptable one. This control makes it difficult for someone to invent a fake number if they don't know the formula, since the program will recognize a number that isn't designed so that the check digit is correct. The check digit can actually be either a number or letter, and can be placed in any position in any consistent position in the overall identification. For example, many states have driver licenses that start with a letter which is derived from a formula applied to the numbers which follow it, and a person trying to create a fictional license will only have a 1 in 26 chance of correctly guessing the letter that should be in the first position based on the numbers.

When using batch processing of data, the data input clerk will often prepare manual **control totals** to be compared with computer-generated totals of entered information in order to ensure accuracy of inputs. These totals include:

- **Record count** – The total number of records entered into the program at that time.

- **Financial total** – The total dollar amount of entries that are financial in nature.

- **Hash total** - The total of values which cannot be meaningfully added together, but which serve as a way to verify the correct entry of these values.

- **Other quantitative total** – The total of some column of numbers, such as check numbers or invoice numbers that can be used to determine that all transactions have been entered as well as that a sequence has not been broken.
For example, assume that the checks written during a particular day are being entered into a checkbook program, and that the data input clerk is working from the following sheet to make the entries:

<table>
<thead>
<tr>
<th>Check Number</th>
<th>Payee</th>
<th>Amount</th>
<th>Account Code</th>
</tr>
</thead>
<tbody>
<tr>
<td>1001</td>
<td>Philipp Corporation</td>
<td>$500.00</td>
<td>307</td>
</tr>
<tr>
<td>1002</td>
<td>Rog Enterprises</td>
<td>$3,000.00</td>
<td>602</td>
</tr>
<tr>
<td>1003</td>
<td>Ruiz Company</td>
<td>$600.00</td>
<td>302</td>
</tr>
<tr>
<td>3006</td>
<td></td>
<td>$4,100.00</td>
<td>1211</td>
</tr>
</tbody>
</table>

After the data input clerk enters each of the checks, the computer will then indicate:

- Checks Entered = 3 (record count)
- Check Number total = 3006 (quantitative total)
- Amount total = $4,100.00 (financial total)
- Account Code total = 1211 (hash total)

The data input clerk would have also determined these numbers by computing them from the input sheet, and the agreement of the clerk’s totals with those of the program will indicate all lines must have been entered correctly.

A program may also perform edit checks on batch-processed data to verify that each individual entry is appropriate, and generate a list of rejected transactions for review by the control clerk.

**EXTENSIBLE BUSINESS REPORTING LANGUAGE (XBRL)**

XBRL is a specification for publishing financial information in the XML format. It is designed to provide a standard set of XML tags for exchanging accounting information and financial statements between companies and analysts. Instead of treating financial information as a block of text (e.g., standard internet page or Word document), it provides a computer-readable identifying tag for each individual item of data. For example, “net income” has its own unique tag and a computer can immediately generate a comparison of net income for multiple companies or periods. XBRL eliminates the costly process of manual data comparison as computers can select, analyze, store, and exchange data in XBRL documents. Another benefit to XBRL is that it reduces the chance of error when generating reports.

- XBRL can handle data in different languages and accounting standards.
- Built upon the XML (eXtensible Mark-up Language) – promulgated through the World Wide Web Consortium, XML is a web-based application development technique that allows designers to create their own customized tags, thus enabling the definition, transmission, validation and interpretation of data between applications and organizations.
- The SEC mandates all public companies file financial statements in XBRL. The SEC uses these XBRL filings to facilitate financial statement review.

**Lecture 9.03**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.
Lecture 9.04

AUDITING ISSUES

When examining a company in an IT environment, the auditor will use a generalized audit software package. This refers to a series of programs that are useful in the auditing process, enabling the auditor to use computer assisted auditing techniques (CAATs). These might include:

- Programs to access client files for purposes of testing. For example, the auditor’s program may access computerized inventory files to determine the location of inventory, perform analytical procedures (such as calculating inventory turnover), or review dates of last purchase and sale in order to identify obsolete or slow-moving inventory.
- Source code comparison programs that can detect unauthorized changes made by the client in programs that the auditor is testing. For example, after the auditor has verified the proper functioning of a copy of the payroll program provided to them by the client for testing, this program would compare the tested program with the one being used by the client to process an actual payroll period to be sure the files are identical.
- Programs that duplicate common functions of client software that can be used to perform parallel simulation, in which the auditor inputs client data in to the auditor's program (created by the auditor) to see if it produces the same results as the client’s program. For example, the auditor might obtain the raw data for an actual payroll period and run it through a payroll program included in the generalized audit software package to see if the checks and payroll records produced are identical to the checks and records generated by the client's program.
- Programs to produce spreadsheets for working trial balances and similar audit needs as well as analyzing data and recalculating balances.

When the client has a program that the auditor wishes to verify and for which there is no appropriate equivalent program available to the auditor, techniques involving the direct use of the client program are required. One approach is known as the test data approach, in which the auditor will develop simulated data to enter into the client’s program. Characteristics of this approach include:

- The auditor can include both valid and invalid data to verify that the program processes appropriate data correctly and rejects inappropriate data.
- The auditor only needs to design simulated data for those valid and invalid conditions that interest the auditor.
- Only one example of each valid and invalid condition needs to be included (since computer programs are consistent in the way they handle items), making this an efficient method of testing.

One danger is that the client may provide the auditor with a program to verify which isn’t the actual program used by the client. To avoid this, the auditor will often include the test data in an integrated test facility, including the simulated data (fictitious transactions) along with actual data during a program run. For example, the auditor may add simulated payroll data to the actual data for a pay period, so that the testing occurs at the same time the actual employee information is being processed (of course, the simulated data is specially coded so as not to be permanently mixed with the real data).

Another use of an integrated test facility approach involves the use of embedded audit modules. These are programs that are implanted in the client's processing system and can perform audit...
procedures on a real-time basis. For conditions that can be appropriately defined, embedded audit modules can identify exceptions as they occur.

An auditor can walk through a specific transaction to evaluate the logic of the process.

If it isn't practical to use an integrated test facility, the auditor may use an approach known as **controlled reprocessing**, in which the auditor supervises the entry of actual client data into the client program to reproduce the results of a previous run of the program by the client. After verifying that the results are identical to the previous run, the auditor knows that the program is the actual one used, and can enter the test data into it at a separate time.

To summarize the techniques available:

<table>
<thead>
<tr>
<th>Actual Client Data</th>
<th>Simulated Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual Client Program</td>
<td>Controlled Reprocessing</td>
</tr>
<tr>
<td>Program Purchased Separately by Auditor</td>
<td>Parallel Simulation</td>
</tr>
<tr>
<td></td>
<td>Test Data (Integrated Test Facility)</td>
</tr>
<tr>
<td></td>
<td>No Relevance to Audit of Client</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Data</th>
<th>Program</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Test Data</strong> (Phony Data) – theoretically only have to check one above and one below credit limit.</td>
<td>Auditor's</td>
</tr>
<tr>
<td><strong>Controlled reprocessing</strong></td>
<td>Client's</td>
</tr>
<tr>
<td><strong>Integrated Test Facility (ITF)</strong> (Dummy Division or file &amp; Fictitious transactions)</td>
<td>Auditor &amp; Client's</td>
</tr>
<tr>
<td><strong>Transaction Tagging</strong></td>
<td>Client's information with a Tag</td>
</tr>
<tr>
<td><strong>Parallel Simulation</strong></td>
<td>Client's</td>
</tr>
</tbody>
</table>

**Trust Services** are governed by SSAE (Statements on Standards for Attestation engagements) and represent attest engagements in which a CPA assesses a client's commercial internet site and reports on whether the system meets one or more of the following **principles** (security, availability for operation, processing integrity, online privacy, confidentiality). For each Principle reported, the
The auditor considers each of the following 4 criteria (Policies, communications, procedures, monitoring).

Both WebTrust and SysTrust are designed to incorporate a seal management process by which a seal (logo) may be included on a client's website as an electronic representation of the practitioner's unqualified WebTrust report. If the client wishes to use the seal (logo), the engagement must be updated at least annually. Also, the initial reporting period must include at least two months. Any of the 5 types of opinions may be issued as discussed in the audit report section.

- **WebTrust** – This engagement provides reasonable assurance that a client's website complies with certain principles and criteria for electronic commerce and assurance about the ability of these systems to adhere to online privacy, consumer protection, certificate authorities along with one or more combinations of the Trust Services Principles and Criteria areas. The CPA performs an examination to determine if the client complied with the trust services criteria and if effective controls were maintained over the system using trust services criteria. Examine the website for:
  - Adequacy of disclosure, Transaction Integrity, Information integrity

- **SysTrust** – This engagement provides reasonable assurance that a client's information system complies with certain principles and criteria for electronic commerce. The “SysTrust” category by itself is a designation given from an engagement by a CPA firm that actually includes one or more combinations of the Trust Services Principles and Criteria areas. The CPA's examination is exclusively designed to determine if a client maintained effective controls over the system based on the trust services criteria. The auditor examines the Information systems for:
  - Availability for operation, Security against unauthorized access, Integrity of system process, Maintainability of system resources

**Lecture 9.05**

**CLASS QUESTIONS**

Please see the Class Questions and Class Solutions for this Lecture at the end of this Section.
CLASS QUESTIONS

Work through the below Class Questions while following along with the respective lectures. Once this is complete, you can begin independently practicing what you’ve learned by quizzing yourself on this course section in your Interactive Practice Questions (IPQ), which can be found in your online Student Dashboard. Your IPQ simulates the computer-based testing experience, and will also help you understand how concepts are applied to the exam. Each question includes answer explanations from expert CPAs that will help you determine why you answered a question correctly or incorrectly. This is key to your success on the CPA Exam.

Lecture 9.03

1. Which of the following is not a major reason for maintaining an audit trail for a computer system?
   a. Deterrent to fraud.
   b. Monitoring purposes.
   c. Analytical procedures.
   d. Query answering.

Questions 2 and 3 are based on the following information. An entity has the following invoices in a batch:

<table>
<thead>
<tr>
<th>Invoice #</th>
<th>Product</th>
<th>Quantity</th>
<th>Unit price</th>
</tr>
</thead>
<tbody>
<tr>
<td>201</td>
<td>F10</td>
<td>150</td>
<td>$ 5.00</td>
</tr>
<tr>
<td>202</td>
<td>G15</td>
<td>200</td>
<td>$10.00</td>
</tr>
<tr>
<td>203</td>
<td>H20</td>
<td>250</td>
<td>$25.00</td>
</tr>
<tr>
<td>204</td>
<td>K35</td>
<td>300</td>
<td>$30.00</td>
</tr>
</tbody>
</table>

2. Which of the following numbers represents the record count?
   a. 1
   b. 4
   c. 810
   d. 900

3. Which of the following most likely represents a hash total?
   a. FGHK80
   b. 4
   c. 204
   d. 810
4. Which of the following types of control best describes procedures to ensure appropriate systems software acquisition?
   
   a. Application.
   b. Physical.
   c. General.
   d. Monitoring.

Lecture 9.05

5. When an auditor tests a computerized accounting system, which of the following is true of the test data approach?
   
   a. Several transactions of each type must be tested.
   b. Test data are processed by the client's computer programs under the auditor's control.
   c. Test data must consist of all possible valid and invalid conditions.
   d. The program tested is different from the program used throughout the year by the client.

6. Which of the following statements is not true of the test data approach when testing a computerized accounting system?
   
   a. The test need consist of only those valid and invalid conditions which interest the auditor.
   b. Only one transaction of each type need be tested.
   c. The test data must consist of all possible valid and invalid conditions.
   d. Test data are processed by the client's computer programs under the auditor's control.

7. After the preliminary phase of the review of a client's computer controls, an auditor may decide not to perform tests of controls (compliance tests) related to the controls within the computer portion of the client's internal control. Which of the following would not be a valid reason for choosing to omit such tests?
   
   a. The controls duplicate operative controls existing elsewhere in the structure.
   b. There appear to be major weaknesses that would preclude reliance on the stated procedure.
   c. The time and dollar costs of testing exceed the time and dollar savings in substantive testing if the tests of controls show the controls to be operative.
   d. The controls appear adequate.

8. Which of the following computer-assisted auditing techniques allows fictitious and real transactions to be processed together without client operating personnel being aware of the testing process?
   
   a. Integrated test facility.
   b. Input controls matrix.
   c. Parallel simulation.
   d. Data entry monitor.
9. Which of the following tasks can be achieved using generalized audit software?

   a. Determining acceptable risk levels for substantive testing of account balances.
   b. Filtering data based on accounts receivable data recording.
   c. Detecting transactions that may be suspicious due to alteration of data input.
   d. Assessing likelihood of fraud based on fraud input factors.

10. An auditor will most likely use computer-assisted audit techniques, rather than manual techniques, when it is necessary to

   a. Examine all data in an accounts payable file.
   b. Review approval of dividends.
   c. Verify unrecorded legal liabilities.
   d. Assess compliance with policies and procedures related to information security.
CLASS SOLUTIONS

1. (c) An audit trail can be a deterrent to fraud (a) as it gives an auditor a means of tracing a transaction from beginning to end increasing the possibility of detection. It assists in monitoring (b) as it allows an auditor to look back at transactions to determine if they have been processed correctly. An audit trail also facilitates query answering (d) as it allows someone to trace a transaction from beginning to end to respond to a query regarding some aspect of the transaction. Analytical procedures involve comparing auditor expectations to client data, regardless of its source, to evaluate the reasonableness of the client's data. Since the source of the client data is not significant, an audit trail is not a significant factor.

2. (b) The record count is the number of items in a batch. This batch includes invoice numbers 201, 202, 203, and 204—a total of 4 records.

3. (d) A hash total is the total of a column of values that have no meaning other than as an identifier. This might include, for example, a total of part or invoice numbers, which does not represent a meaningful quantity. If it matches the check figure, however, it may indicate that all line items on an invoice have been entered. The number 810 is the total of the invoice numbers, not a meaningful value, so this represents an example of a hash total. Answer (a) is incorrect because it appears to be an accumulation of all letters, plus a sum of the numbers. The total number of records (or record count) is 4 (b), which is a meaningful total. The number 204 is simply an invoice number of the last invoice in the batch, not a total (c).

4. (c) General controls typically encompass all controls except application controls; generally, this includes the change controls. Application controls (a) typically apply to application software, not systems software. Physical (or mechanical) controls (b) are general controls that typically involve such things as locks on doors and identification badges to allow only appropriate personnel into sensitive areas; acquisition of appropriate software is a qualitative judgment. Monitoring (d) typically occurs after a system is installed and operating; it is too late to ensure appropriate software acquisition at that point.

5. (b) The test data approach involves running data compiled by the auditor through the client's IT system. The data will include certain errors, and be used to determine if the client's IT system will deal with them appropriately. The test data will only include errors or conditions that the auditor wishes to test, not all possible conditions (c) and need only include one example of each condition the auditor wishes to test (a). The data is processed through the same program used by the client throughout the period (d) to determine if it was working properly.

6. (c) The test data approach involves running data compiled by the auditor through the client's IT system, under the auditor's control (d). The data will include certain errors, and be used to determine if the client's IT system will deal with them appropriately. The test data will only include errors or conditions that the auditor wishes to test (a), not all possible conditions (c) and need only include one example of each condition the auditor wishes to test (b).

7. (d) After obtaining an understanding of the client's internal controls, the auditor will test those controls that the auditor believes to be adequate for preventing or detecting and
correcting material misstatements on a timely basis. The auditor would not test controls that do not appear reliable (b). Nor would the auditor test controls when the cost of testing exceeds the likely savings in the performance of additional audit procedures that would result from relying on the control (c). The auditor would also decide not to test controls that accomplish the same benefits of other controls within the system (a).

8. **(a)** Using the integrated test facility approach, the auditor will run fictitious transactions through the client's system along with the client's data, to make certain that it is receiving the same treatment and enabling the auditor to compare results to expected results. Parallel simulation (c) involves running the client's data through an auditor developed software package. The auditor can compare the results to the client's results to see if the client's system processed the data similarly. An input controls matrix (b) and monitoring of data entry (d) are both input controls and do not provide evidence about the processing of data.

9. **(b)** Generalized audit software (GAS) typically performs many of the tasks auditors formerly did manually, particularly the more mechanical processes, such as filtering data. Artificial intelligence has not progressed to the point where GAS is able to apply judgment, such as (a) determining acceptable risk levels, (c) determining suspicious transactions, or (d) assessing the likelihood of fraud.

10. **(a)** Computer-assisted audit techniques (CAAT) are efficient and effective at handling large amounts of data in machine-readable form when the task involves a repetitive process and the identification or accumulation of objective information. They can be used, for example, to obtain statistical data, such as the number of times, or the frequency with which, an error occurred, or accumulate amounts. They cannot be used to apply judgment in interpreting data or drawing subjective conclusions. As a practical matter—due to the volume of data, to examine all data in an accounts payable file generally would require CAAT. CAAT can readily determine whether each account in the file contained all of the appropriate information. Reviewing approval of dividends (b) generally involves reviewing the minutes of board of director meetings; while these may be in a machine-readable form, this task involves interpreting the minutes, a skill involving subjectivity that is generally beyond the scope of CAAT. Verifying unrecorded legal liabilities (c) involves applying judgment to interpret the likelihood that the liability will be incurred, for example, or determining the amount of the liability, a skill requiring subjectivity and generally beyond the scope of CAAT. Depending on the environment, assessing CAAT can quantify compliance with policies and procedures related to information security by determining the frequency with which noncompliance occurs, including separating each type of noncompliance. It cannot, however, assess compliance (d) as that requires judgment to determine which actions or omissions resulting in noncompliance are significant to information security, such as lax protection of passwords, and which are not, such as instances in which information is being retained briefly longer than the entity's retention policies mandate.