superfastCPA

AUD

2021 SuperfastCPA Review Notes

[Updated for the July 2021 changes]

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I. ETHICS, PROFESSIONAL RESPONSIBILITIES AND GENERAL PRINCIPLES

A. NATURE AND SCOPE

1. NATURE AND SCOPE OF AUDIT ENGAGEMENTS

The purpose of an audit is to have an independent auditor issue an opinion as to whether the financial statements are presented fairly according to the applicable framework.

Non-Issuer Audits

These are non-public companies, and audits of non-issuers are subject to the clarified auditing standards (AU-Cs) issued by Auditing Standards Board (ASB).

Objectives of an Audit of Financial Statements According to AU-C 200

- Obtain reasonable assurance that the financial statements are free from material error, which allows the auditor to express an opinion whether the statements are present fairly according to the applicable framework.
- Report on the financial statements and communicated as required by GAAS (generally accepted auditing standards), in accordance with the auditor's findings.

Issuer Audits (public companies)

These audits are subject to the PCAOB's Auditing Standards (AS 1015 for example).

Objective of the Independent Auditor According to AS 1001

The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his audit has been made in accordance with the standards of the PCAOB. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and to identify those circumstances in which such principles have not been consistently observed in the preparation of the financial statements of the current period in relation to those of the preceding period.

In both cases the main objective of an audit is to have an independent auditor express an opinion on whether the financial statements are presented fairly based on the applicable reporting framework.

Assertions

The "assertions" are key to the whole audit process. The assertions are the underlying claims made by management about the financial statements. When management gives the auditor their listing of PP&E for example, management is essentially making the "claim", or assertion, that the items on that list actually exist, that the list is complete (nothing left out), that the business actually owns the items listed, and that the values of the items are listed correctly. The auditor then assesses the risk of material misstatement based on these assertions and performs audit procedures. That's how the audit works in a nutshell.

It helps a LOT to just "think" about the meaning of the words, especially in the context of the question being asked. For example, "completeness"… this includes procedures or tests to determine if a population is complete- or if everything has been included that should be included.

They are grouped into 3 categories:

Account balances (4 assertions)

- Existence: This assertion means that all the assets, liabilities, and equity actually exist.
- Completeness: That all assets, liabilities, and equity that should have been recorded, have been recorded. That nothing has been left out.
- Rights and Obligations: That the entity holds or controls the rights to its assets, and the liabilities are that of the entity. Any restrictions on either need to be disclosed.
- Valuation and Allocation: That the assets, liabilities, and equity are included in the financial statements at the proper amounts.

Presentation and disclosure (4 assertions)

- Occurrence and Rights & Obligations: That the disclosed events and transactions have actually occurred and pertain to the entity.

- Completeness: That all disclosures that should have been included have been included, with nothing left out.
- Classification and Understandability: That the financial information is appropriately presented, described, and clearly expressed.
- Accuracy and valuation: That the financial information is disclosed fairly and at the appropriate amounts.

Classes of transactions and events (5 assertions)

- Accuracy: That amounts and other data have been recorded appropriately.
- Occurrence: That transactions and events recorded actually occurred.
- Completeness: That all transactions and event that should have been recorded have been recorded, with nothing left out.
- Cutoff: That the transactions have been recorded in the proper period.
- Classification: That the transactions have been recorded in the proper accounts.

Read through the assertions until you understand them. This makes everything about AUD easier to understand.

2. NATURE AND SCOPE OF GAO AUDITS

The GAO issues Government Auditing Standards (Yellow Book) - also referred to as GAGAS (generally accepted government auditing standards) - and these standards apply to audits involving federal government programs or activities, or other entities that receive federal funds.

The objective of a financial statement audit under GAGAS is similar to a non-government audit: determining whether the financial statements are presented fairly based on the applicable reporting framework.

Additionally, GAGAS audits require separate reporting on internal controls and adherence to applicable laws and regulations, depending on the entity being audited. Therefore, the scope of a GAGAS audit is larger than a non-government audit.

Single Audits

State and local government agencies that spend at least $750,000 in federal funding must get a "single audit".

The point of a single audit to verify that federal funds have been spent according to the programs the funds were received for.

Materiality for single audits is determined separately for each major federal financial assistance program.

Governmental auditing standards require a separate report on internal control that includes a description of the scope of the auditor's work in obtaining an understanding of internal control. This report will also include any significant deficiencies or material weaknesses noted. BUT, the regular audit report and the report on internal controls can be combined.

A government audit will also include a report on compliance with laws, regulations, and the provisions of any grant agreements.

So an audit subject to the yellow book standards includes 3 reports:

- An audit report.
- A report on internal control (this and the audit report can be combined).
- A report on any applicable compliance with laws or regulations.

In a government audit, the auditor is required to report any fraud or illegal acts to outside authorities IF:

- Management fails to report the information as required by law,
- OR, if management fails to take timely action to respond to the fraud or illegal act.

3. NATURE AND SCOPE OF OTHER ENGAGEMENTS

For non-audit engagements, there are basically two categories:

1) Engagements dealing with historical financial statements that are <u>not a full audit engagement</u>.

The AICPA's SSARs govern these types of engagements, and they include:

- Reviews - provides limited assurance, is an attest engagement.
- Compilations - provides no assurance, is an attest engagement.
- Preparation of financial statements - provides no assurance, is not an attest engagement.

These services apply to non-issuers (non-public companies). Each of these engagement types require an engagement letter, and a report from the auditor is part of both reviews and compilations, but there is no report issued with a preparation of financial statements. See the details of each engagement type below.

2) Engagements dealing with written representations or subject matter other than historical financial statements.

The AICPA's Statements on Standards for Attestation Engagements (SSAEs) apply to these types of engagements. These include:

- Examination engagements.
- Review engagements (different than a financial statement review above).
- Agreed-upon procedures engagements.

SSARs or “Statements on Standards for Accounting and Review Services”

These standards apply to “reviews”, “compilations”, and now “preparation of financial statements”.

A review is an assurance engagement & an attestation engagement that provides “limited assurance” that there are no material modifications that should be made to the financial statements. For a review, the auditor must be independent.

The basics of a review are:

- Possess knowledge of a client’s industry.
- Apply analytical procedures.
- Perform inquiries of management.
- Obtain a representation letter.

Each page of an entity’s financial statements that have been ‘reviewed’ should include the reference “See Accountant’s Review Report”

In a review engagement, the auditor is NOT required to obtain an understanding of internal controls.

A compilation is basically assisting management to draft the financial statements, without providing ANY level of assurance. It is an attestation engagement but NOT an assurance engagement. Also, a compilation can be performed for prospective or pro-forma information in addition to historical financial statements.

An auditor does NOT have to be independent to do a compilation for a client since no assurance is provided. BUT, if the auditor is not independent, the accountant should disclose this fact in the compilation report.

The compilation report explicitly states that the financial statements have not been audited, and that the accountant has compiled the financial statements.

Remember that no procedures whatsoever are performed on the data in a compilation. The auditor is expected to understand the client and the client's industry, but no audit procedures of any kind are performed since no assurance is being provided.

Preparation of financial statements: this is what it sounds like. The accountant takes the information from management and prepares the financial statements. A preparation is a nonattest service.

The accountant does NOT have to be independent for this type of engagement.

There should be an engagement letter that outlines management's responsibilities & the accountant's responsibilities.

Each page of the financial statements should include a statement that no assurance is provided.

SSAEs or "Statements on Standards for Attestation Engagements"

For all types of engagements under the SSAEs, the CPA needs to be independent.

Examinations

These are in-depth engagements where the CPA ultimately obtains reasonable assurance about the subject matter being fairly stated or in accordance with applicable criteria (that it is what it says it is). It differs from an audit in that it's not dealing with historical financial statements. A report is issued that provides the CPA's opinion as to whether the subject matter conforms to the criteria.

Attestation Review Engagements (not a financial statement review)

In this type of engagement, the CPA is providing limited assurance that the subject matter conforms to the criteria, and again, the subject matter can be a number of things, just not historical financial statements or it would be a financial statement review. A report is issued that contains a conclusion about whether there is a need for any material modifications in order to be in accordance with the criteria.

Agreed Upon Procedures Engagements

In this type of engagement, a CPA is engaged to perform procedures and report findings based on the criteria set by the specified parties. A report is issued that describes the procedures performed and the findings as a result of the procedures.

B. ETHICS, INDEPENDENCE, AND PROFESSIONAL CONDUCT

1. AICPA CODE OF PROFESSIONAL CONDUCT

One of the main points of the code of professional conduct is for CPAs to go above and beyond the minimum requirements to show the public that CPAs willing to accept responsibility to the public.

Along with that, CPAs should not only be competent with the professional services they provide, they should also cooperate with other CPAs to improve the accounting profession.

The 3 main groups of rules that CPAs must honor involve:

- Integrity
- Objectivity
- Independence

As far as gifts from clients go, the 2 things to keep in mind are:

- Gifts from clients cannot violate the client's laws or regulations, OR the CPA's laws or regulations.
- Even if a gift isn't explicitly violating any laws, it still needs to be "reasonable under the circumstances".

When a CPA disagrees with their superior about the treatment of a significant transaction, if the discussion with the superior does not resolve the issue, then the CPA should go over the superior's head.

Even if a CPA has not handled a certain type of transaction or tax issue before, they can still accept such engagements if they believe in good faith that they can research the issues and handle them properly.

Outsourcing professional services requires the notification and approval of the client. If the client doesn't want any of their services outsourced, the CPA should either not outsource the work, or not accept the engagement in the first place.

The client controls who a CPA can release audit documentation to, unless ordered by a court or the CPA society's quality review board. Even if a CPA firm is purchased, the client has to agree that the purchaser can access the audit documentation.

Also, client records are owned by the client and must be returned to the client upon request, even if the CPA has not been paid yet. Schedules or workpapers that the CPA has prepared do NOT need to be returned to the client if the client has not paid.

A CPA that fails to pay their own income tax is considered an act discreditable to the profession.

A CPA cannot receive a contingent fee for attest-related services. A CPA can receive a contingent fee for a private letter ruling.

Accepting a commission for recommending a product to an audit client is essentially a kickback and is prohibited.

Tax accountants can accept referral fees and commissions if they are disclosed to the client.

The only times a CPA should provide confidential client information to another party is:

- A review of the CPA's professional practice by the state CPA society.
- An inquiry from the professional ethics division of the AICPA.
- A court-ordered subpoena.
    - (A mere request or letter from the SEC or IRS does NOT count, and the CPA should never provide client information until there is an actual court-ordered subpoena).

As long as the information is accurate, informative, and truthful, a CPA can advertise his or her services like other businesses advertise.

Independence Rules

All CPAs should be independent when involved in attest services.

If the code and its interpretations do not directly provide guidance for a certain situation, then the conceptual framework should be applied.

Threats to independence are concentrated in 4 areas:

- Financial relationships: A audit partner can't own stock in an audit client.
- Employment relationships: An audit partner cannot be on the board of an audit client.
- Family relationships: An audit partner should not audit his brother's company.

- Consulting relationships: An audit firm cannot provide internal audit consulting to an audit client.

Covered Members

You'll see questions on the exam about "covered members", which means someone who falls under the independence rules based on their situation. The following would be considered covered members:

- Any member of the attest engagement team.
- Any person in a position to influence the attest engagement.
- A partner or manager that provides more than 10 hours of nonattest services to the client within the fiscal year.
- A partner in the same office in as the lead engagement partner.

If a "covered member" is very wealthy and has no investments that are individually materially to that member, they still cannot have a direct investment in an attest client, no matter how small. That includes mutual funds.

The member's spouse also cannot have a direct financial interest.

A covered member can have a car loan with a client bank, as long as the car adequately.

An audit firm can lease office space from an attest client as long as the operating lease is on normal terms and all amounts are paid on time and in accordance with the terms of the lease.

2. REQUIREMENTS OF SEC AND PCAOB

SEC Rules

The rules from the SEC for independence and professional conduct are very similar to the AICPA rules.

Main requirements as a CPA to audit a public company:

- Must be in good standing and registered under the laws of the CPA's state.
- Must be independent and capable of exercising objective and impartial judgement.

Other things to know:

- The CPA (firm) or the CPA's direct family members can't have a direct investment in an audit client such as stocks or bonds.
- Members/employees of the firm own more than 5% of the stock of an audit client.
- Can't have direct or material indirect investment in a company that the audit client has a material investment in, nor in a company that has a material investment in the audit client.
- Can't have a credit card issued from an audit client if the balance is $10,000 or more owed to the client.
- An audit client can't make a direct investment in the accounting firm.

PCAOB Rules

SOX created the PCAOB to govern public company audit firms and creates standards for such audits.

Specific rules you might see a question on:

- Any kind of contingent fee charged to an audit client impairs independence.
- Members of the audit firm impair their independence if they perform any tax service to a person in a financial reporting oversight role from the audit client.
- Tax consulting services can be performed for a public company audit client if it is pre-approved by the client's audit committee. The CPA firm is required to describe the scope and compensation for the service, discuss it with the audit committee, and document the discussion.
- Other non-audit services can be approved in this same way, except for consulting related to internal controls over financial reporting.

3. REQUIREMENTS OF THE GAO AND THE DOL

GAO Standards

Again, these are very similar to the AICPA code of professional conduct.

Auditors who perform GAGAS audits are expected to be independent, and adhere to the following ethical principles:

- The public interest.
- Integrity.
- Objectivity.
- Proper use of government info and resources in performing audits; auditor should never use government resources for personal gain.
- Professional behavior including avoiding conflicts of interest, complying with applicable laws and regulations, and meeting technical and professional standards.

The GAO's ethical principles apply to firms that audit federal government agencies, or schools/entities that receive federal grants. They do not apply to audit firms that audit public companies.

According to the GAO's standards, there are 3 types of impairments to independence:

- Personal
- External
- Organizational

GAO standards allow for auditors to perform non-audit services for their audit clients. One thing they cannot do is design an entity's accounting system and then audit the entity.

Auditors that perform GAGAS audits should complete 24 hours of yellowbook CPE every two years.

Threats to Independence from GAGAS Conceptual Framework

- Self-interest threat: that financial reasons or other personal interests will inappropriately influence the auditor's judgment or behavior.
- Self-review threat: if the auditor has previously provided nonaudit services, they might not appropriately evaluate previous judgments or services provided as they make significant judgements on an GAGAS engagement.
- Bias threat: that the auditor might take a position or make a judgment that is not objective based on political, ideological, social, or other personal convictions.
- Familiarity threat: that a relationship with management or personnel of an audited entity might result in judgements that are not objective.
- Undue influence threat: that influences or pressures from sources external to the audit organization could result in judgments that are not objective.
- Management participation threat: the auditor taking on a role in management or performing management functions on behalf of

the audited entity could result in judgments that are not objective.

- Structural threat: that the placement of the audit organization within a government entity, in combination with the structure of the government entity being audited could affect the audit organization's ability to perform work and report results objectively (*this threat is specific to the GAO standards and isn't included in the AICPA's conceptual framework*).

Department of Labor Rules

The DOL rules in this context mostly deal with the audit of employee benefit plans under ERISA.

Most DOL audits follow government auditing standards, which include audits of compliance with laws or evaluating the effectiveness achieving program results.

Like with the other rules, the big overriding rule is that auditors must be independent. The two broad categories that would impair independence are financial (having a direct financial interest in an entity to be audited) and employment ties to a plan sponsor.

4. PROFESSIONAL SKEPTICISM AND PROFESSIONAL JUDGEMENT

Due professional care requires the auditor exercises professional skepticism. Professional skepticism has several key tenants:

- Includes a "questioning mind" and a "critical assessment of audit evidence".
- Needs to be exercised through the entirety of the audit process.
- Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence.
- The auditor neither assumes management is lying, nor assumes unquestioned honesty.
- The auditor should not be satisfied with less than persuasive evidence simply because of a belief that management is honest.

C. TERMS OF ENGAGEMENT

1. PRECONDITIONS FOR AN ENGAGEMENT

The preconditions for an audit are:

- Determine whether the financial reporting framework to be applied is acceptable.
- Obtain an agreement of management that it acknowledges and understands its responsibility:
  - for the preparation and fair presentation of the financial statements in accordance with the applicable reporting frameworks.
  - 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.
  - to provide the auditor with:
    - access to all information, documents, records, etc that is relevant to the preparation of the financial statements.
    - additional information that the auditor may request for purposes of the audit.
    - unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

2. TERMS OF ENGAGEMENT AND ENGAGEMENT LETTER

The auditor needs to agree with management to the terms and only accepts the engagement if the preconditions for an audit exist and an understanding of the terms is agreed to by the auditor and management (or those charged with governance).

These terms are agreed to in the engagement letter, which contains:

- The objective and scope of the audit of the financial statements.
- The responsibilities of the auditor.
- The responsibilities of management.
- A statement addressing the inherent limitations of an audit that could still lead to missing a material misstatement that exists.
- Identification of the applicable reporting framework for the audit.
- Reference to the expected form and content of any reports to be issued by the auditor.

D. REQUIREMENTS FOR ENGAGEMENT DOCUMENTATION

The overriding idea behind audit documentation is to compile documentation to the point that an experienced auditor that had no previous connection with the audit could look through the documentation and understand:

- The nature, timing, and extent of audit procedures performed.
- The results of the audit procedures performed, and the audit evidence obtained.
- Significant findings or issues arising during the audit, the conclusions reached, and significant professional judgements made in reaching those conclusions.

Considerations in actually documenting the audit:

- The identifying characteristics of the specific items or matters tested should be documented.
- Who performed the audit work and the date such work was completed should be documented.
- Who reviewed the audit work and the date and extent of such review should be documented.

The actual audit workpapers and copies of significant contracts, agreements, documents, schedules, etc. make up the "audit file", which should be in physical or electronic form.

The auditor should document the report release date in the audit documentation, and the final audit file should be assembled no later than 60 days after the report release date. The retention period for the final audit file should not be less than 5 years from the report release date. The auditor should adopt reasonable procedures to maintain the confidentiality of the client information.

E. COMMUNICATION WITH MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE

1. PLANNED SCOPE AND TIMING OF AN ENGAGEMENT

When communicating with management regarding the audit, an overview of the audit process should be provided but it should not be so detailed as to reduce the effectiveness of the audit procedures, meaning that the audit procedures shouldn't become completely predictable to management. The exact details of the auditor's plan for tests and procedures should not be communicated.

The auditor should communicate:

- How the auditor will address the risks of material misstatements whether due to fraud or error.
- Issues regarding internal control and the internal audit function (if exists).
- The application of materiality in the context of the audit.

2. INTERNAL CONTROL RELATED MATTERS

The auditor should communicate in writing any significant deficiencies or material weaknesses in internal control to management or those charged with governance. This communication should be provided by the audit report date and not later than 60 days after the report release date.

Significant deficiency in internal control: A deficiency or combination of deficiencies in the design or operation of a control that doesn't prevent, detect, or correct misstatements on a timely basis. This is less severe than a material weakness.

Material weakness in internal controls: A deficiency or combination of deficiencies that results in a reasonable possibility that a material misstatement will result as a result of the deficiency.

The communication should include:

- The definition of material weakness and if applicable, the definition of a significant deficiency.
- A description of the significant deficiencies and material weaknesses and an explanation of the effects.
- Elements that explain:
    - That the purpose of the audit was for the auditor to express an opinion on the financial statements.
    - The audit included consideration over internal control but not for the purpose of expressing an opinion on internal control.

- The auditor is not expressing an opinion on the effectiveness of internal control.
- The consideration over internal controls was not designed to detect all possible deficiencies in internal control and that there could be other deficiencies in internal control that weren't identified.

There are many items that would require communicating to management or those charged with governance besides the scope of the audit or internal control deficiencies, such as:

- Significant misstatements discovered by the auditor but corrected by management.
- Disagreement with management on significant issues that could affect the financial statements.
- Management's consultations with other accountants regarding significant accounting matters.
- Any significant difficulties in dealing with management in performing the audit such as not making key information available to the auditor.

F. A FIRM'S SYSTEM OF QUALITY CONTROL

Statements on Quality Control Standards (SQCSs)

These are statements issued by the AICPA's Auditing Standards Board.

They apply to everything about accounting and auditing engagements and provide guidelines for implementing a quality control system.

6 Elements to a quality control system

- Leadership responsibilities such as "tone at the top".
  - Emphasis should be on performing work that complies with professional standards.
- Relevant and ethical requirements.
  - Policies should be implemented that help ensure that firm personnel comply with applicable ethical requirements.
- Acceptance and continuance of clients and specific engagements.
  - One of the main purposes for QC regarding client acceptance is so a firm only accepts engagement that it is qualified to perform.
  - On the other side, to minimize the chances of working with a client whose management lacks integrity.
- Human resources.
  - QC procedures over human resources should ensure the firm has sufficient, competent personnel to handle the firm's engagements in accordance with the applicable

requirements and issue required reports required by the engagements.

- Engagement performance.
    - One primary purpose is to ensure that engagements are adequately supervised.
    - Needs to provide elements to support consistency of engagement performance, supervision, and review functions.
- Monitoring- meaning ongoing quality control efforts.
    - Ongoing review of the QC procedures to ensure that they are appropriate, relevant, and operating effectively.

The engagement partner is responsible for overall audit quality.

A firm's QC procedures can be communicated to employees orally or in writing.

When there is a difference of opinion on a significant matter between members of the audit team, the details of reaching a resolution should be documented.

The nature and extent of a firm's QC procedures are based on the firm's size, the nature of the firm's practice, and cost/benefit considerations.

The SQCS's scope is limited to auditing, accounting, and review services. The procedures can obviously be applied to a firm's other service areas, but the SQCSs do not require it.