Recent Developments in Auditing

10 CPE Hours
CPAPDH11

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Field of study:	Auditing
Level of knowledge:	Overview
Prerequisite:	General understanding of auditing standards
Advanced preparation:	None
Recommended CPE hours:	10
Course qualification:	Qualifies for both NASB QAS and Registry CPE credit based on a 50-minute per CPE hour measurement.
CPE sponsor information:	NASBA Registry Sponsor Number: 138298

COURSE DESCRIPTION

The objective of this course is to review the latest developments affecting audit engagements.

Part of planning an audit involves consideration of the business and economic environment in which the client operates. Thus, auditors need to be aware of the various types of fraud that clients and employees may be committing, especially in light of myriad lawsuits against auditors and accountants. In addition to applying techniques to limit their liability to their clients and third parties, auditors are confronting other major problems facing the accounting field, including compliance with the Sarbanes-Oxley Act. The peer review comments and new auditing statements provide further guidance on current issues. To deal with the volatility in the business climate, auditors should focus their efforts in key areas and should take lessons from litigation. Additionally, in this course, auditors will learn how to perform more efficient engagements, understand the guidance found in SAS Nos. 128 to 131 and new SSAE No. 18, and much more. The course focuses recalling, recognizing and identifying rules related to auditing standards including new developments pertaining to those standards.

Section 1:
After reading the Section 1 course material, you will be able to:

- Identify a fact related to the concentration of auditors in the larger public company market
- Recognize a recommendation made to address auditor liability
- Recall some of the AICPA's top technology issues affecting auditors
- Identify some of the auditor requirements of Section 404 of Sarbanes-Oxley Act
- Identify some of the reasons why an entity may no longer wish to stay public
- Recall some of the whistleblower protections for employees of public companies including the incentives given to such whistleblowers to report to the SEC
- Identify some of the key deficiencies found in peer review

Section 2:
After reading the Section 2 course material, you will be able to:

- Identify an example of a coverage ratio
- Recognize some of the common pitfalls that continue to expose accountants to loss in litigation
- Identify some of the top ten actions to minimize the risk of being sued
- Identify actions that can reduce time and increase audit efficiency in an audit engagement
- Recognize an appropriate response to a comfort letter request
- Identify an action an accountant should take if he or she identifies a deficiency in internal control
- Recall when an employee benefit plan must have an audit
- Recognize actions to reduce cheating in a company

Section 3:
After reading the Section 3 course material, you will be able to:

- Identify at least one procedure an external auditor should perform with respect to internal auditors

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SECTION 1: Auditing Developments

I. Attempting to Limit Auditor's Liability

Auditors on both sides of the Atlantic are trying techniques to limit their liability to their clients and third parties.

Europe is moving ahead with liability limits:

In Europe, auditors have had much greater success with limiting liability than those in the United States. In particular, the Big Four have won several battles to limit their liability, with the most recent victories occurring in the U.K. and Belgium. The goal appears to be to win Europe-wide limits on liability and then attempt a similar cap in the United States. With the size of claims in today's litigious environment, any one of the Big Four is one major claim away from going out of business.

The U.K. government has passed legislation that allows auditors to negotiate with companies for liability caps and provide for proportionate responsibility for losses incurred. The result is that damages against auditors are limited to only a portion of the total amount of loss deemed a direct result of the audit, with management and others absorbing the remainder. Presently, auditors can be liable for all damages if other defendants are insolvent.

In the United States, auditors have been unable to push legislation that would limit liability. As a result, auditors are limiting liability contractually by placing liability caps in their engagements letters. Although the liability cap approach may protect auditors against their clients who are a party to the engagement letter contract, it does not help such U.S. auditors shield themselves against third-party liability.

Why use liability caps in the first place?

Placing liability caps and indemnification clauses in engagement letters is nothing new. Firms in all industries, from architects to CPAs, have used them to limit liability. In the wave of a series of sizeable liability claims against the Big 4, liability cap provisions have given the Big 4 and other firms partial liability protection by limiting the claim settlement due to the client in the event of a lawsuit. Because all of the Big 4 use liability cap provisions to some extent, management and audit committees have little choice but to accept them. This is the risk that exists when there are only four major national accounting firms to perform the super majority of SEC audits.

Liability caps are an effective and secretive way for auditors to limit liability because engagement letters are generally not published in proxy reports. Thus, any liability limits inside the engagement letter may go unnoticed by shareholders and third parties.

Critics of liability limitations claim that auditors should be required to disclose the liability caps and indemnifications in their proxy statements. Recently, the SEC has challenged use of certain types of liability caps used by the Big 4, asserting they taint independence.

To date, the AICPA and SEC have different opinions as to whether an auditor taints his or her independence if he or she enters into an agreement with a client that indemnifies the accountant against losses due to the accountant's or client's negligence. The following table compares each organization's current position on the matter:

Type of Indemnification Clause	**Independence Impaired?**	
	SEC (1)	AICPA (2)
Indemnity against accountant's negligence	Yes	Yes
Indemnity against client's negligence	Yes	Yes
Indemnity against knowing misrepresentations made by management	Yes	No

(1) Application of the Commissioner's Rules on Auditor Independence Frequently Asked Questions, Other Matters, Question 4, Section 602.02 of the Codification of Financial Reporting Policies, SEC Office of the Chief Accountant.
(2) ET sec. 1.228.010 of AICPA Code of Professional Conduct.

Previously, the SEC ruled that an accountant's independence would be impaired if he or she enters into an agreement with an SEC client that indemnifies the accountant for either the accountant's or client's negligence. The SEC's reasoning is based on the argument that the existence of an indemnity agreement may "easily lead to the use of less extensive or thorough procedures that would otherwise be followed."[1] To date, there has been little movement in the SEC's position to suggest that SEC company auditors will be permitted to use indemnification clauses in the near future.

The AICPA has taken a different tact as noted in Ethics Ruling No. 94, *Indemnification Clause Engagement Letters.* Specifically, in ET sec. 1.228.010 of the AICPA Code of Professional Conduct, *Indemnification of a Covered Member*, the AICPA has concluded that a clause in which the client indemnifies the auditor from any liability and costs resulting from knowing misrepresentations by management does not impair auditor independence. However, an indemnification of the auditor for client negligence or auditor negligence would impair independence.

Current status

With myriad lawsuits against auditors and accountants, firms are becoming quite aggressive in insisting on indemnification clauses in their engagement letters as a condition of performing the engagement. In particular, with only four major accounting firms to

[1] *Application of the Commission's Rules on Auditor Independence- Frequently Asked Questions, Other Matters*

perform the majority of SEC audits, the Big 4 are forcing the indemnification issue. Their actions have trickled down to regional and local firms that perform work primarily for non-SEC companies.

In response to the more active use of indemnification clauses, the Federal Financial Institutions Examination Council (FFIEC) published a document entitled, *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letter.*

The FFIEC advisory was published in response to the use of indemnification clauses in agreements with various financial institutions. In the Advisory, the FFIEC challenged the use of such clauses stating that such clauses are unsafe and unsound. Further:

1. Agreements by financial institutions to limit external auditor liability may weaken the external auditors objectivity, impartiality, and performance, thereby reducing the ability to rely on external audits.

2. Entering into such indemnity agreements, in connection with either auditor or client negligence, is an unsafe and unsound practice.

3. Financial institutions should be aware that their insurance policies may not cover them if such clauses are included.

4. Financial institutions should be careful not to enter into agreements that mandate Alternative Dispute Resolution (ADR) or waive jury trials.

ET sec. 1.400.060 of the AICPA Code of Professional Conduct (formerly Ethics Interpretation 501-8), *Indemnification and Limitation of Liability Provisions*, further deals with this issue as follows:

> Certain governmental bodies, commissions, or other regulatory agencies (collectively, regulators) have established requirements through laws, regulations, or published interpretations that:
>
> - prohibit entities subject to their regulation (regulated entity) from including certain types of indemnification and limitation of liability provisions in agreements for the performance of audit or other attest services that are required by such regulators or
>
> - provide that the existence of such provisions disqualifies a member from rendering such services to these entities.
>
> For example, federal banking regulators, state insurance commissions, and the SEC have established such requirements.
>
> If a member enters into or directs or knowingly permits another individual to enter into a contract for the performance of audit or other attest services that are subject

to the requirements of these regulators, the member should not include or knowingly permit or direct another individual to include an indemnification or limitation of liability provision that would cause the regulated entity or a member to be in violation of such requirements or disqualify a member from providing such services to the regulated entity. A member who enters into or directs or knowingly permits another individual to enter into such an agreement for the performance of audit or other attest services would be considered in violation of the "Acts Discreditable Rule" [1.400.001].

What impact does ET sec. 1.400.060 have on the auditor?

ET sec. 1.400.060 states that an indemnification and/or limited liability clause may not be used if it is prohibited by applicable law or regulation, or violates ethics rulings. Thus, if use of such a clause violates the rules of a regulated entity that would result in the auditor being disqualified from providing the services to that regulated entity, the indemnification clause would be prohibited.

This result does not impact the use of certain indemnification clauses for a non-regulated entity such as a traditional manufacturing or distribution entity. In such a case, use of the indemnification clause would be subject to ET sec. 1.400.060 which is addressed previously.

If an entity is non-public, and not subject to SEC or any other regulatory rulings, an indemnity clause that protects the auditor against known misrepresentations by management does not impair independence.

Examples of clauses and comments: Assume the client is a nonpublic, non-regulated entity

1. ***Auditor Indemnified Against Claims Based on Knowing Misrepresentations by Audit Client's Management:***

   Company X hereby indemnifies Joe Auditor, his partners, principals and employees and holds them harmless from all claims, liabilities, losses and costs arising in circumstances where there was a *misrepresentation by the audit client's management*, regardless of whether such person was acting in Company X's interests.

Conclusion: This clause would not impair independence as it indemnifies auditor against all claims due to client's knowing misrepresentation.

What if the clause indemnifies the auditor for claims based on the auditor's negligence?

Example:

> Company X hereby indemnifies Joe Auditor, his partners, principals, and employees, and holds them harmless from all claims, whether a claim be in tort, contract, or otherwise, from *any damages relating to services* provided under this engagement letter, or
>
> Company X hereby indemnifies Joe Auditor, his partners, principals, and employees, and holds them harmless from all claims, whether a claim be in tort, contract, or otherwise, for *any damages relating to services* provided under this engagement letter, except to the extent finally determined to have resulted from the *gross negligence, willful misconduct or fraudulent behavior* of Joe Auditor related to such service.

Conclusion: The above clause would impair independence because it indemnifies the auditor against all claims based on auditor's negligence.

Observation: By indemnifying the auditor for client misrepresentations, there is a significant deterrent to management committing fraud as it shifts to the client the responsibility for making proper representations to the auditor. This type of clause encourages management to completely and accurately disclose and communicate all pertinent matters to the auditor.

The SEC has been quite clear that when an accountant who enters into "an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts… the accountant is not independent."[2] If ethics permitted such an indemnification clause, an auditor would be encouraged to perform sub-par work knowing he or she had an insurance policy in the indemnification clause.

Would limited liability be successful in the United States?

There is little evidence that meaningful limited liability reform for auditors is coming to the United States anytime soon. The litigation community continues to be successful in thwarting limited liability for any major profession, including medical professionals and auditors. Simply put, there is too much money to be made when plaintiff lawyers sue the auditors of SEC companies. At this juncture, it is likely that significant reform in limited liability will occur in Europe before it reaches the United States.

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[2] SEC, Office of the Chief Accountant, *Application of the Commission's Rules on Auditor Independence Frequently Asked Questions, Other Matters- Question 4*.

U. S. Chamber of Commerce Proposal- Auditor Liability Limitations

> ***"None of us regulators has a clue what to do if one of the Big Four failed…. If one of the Big Four were to collapse, the best accountants could choose to quit the profession."***

- William McDonough, former chair of PCAOB

The U. S. Chamber of Commerce came to the rescue of auditors by publishing a report that proposed limiting auditor liability. In its policy paper entitled, *Auditing: A Profession at Risk*, the Chamber developed a framework to ensure long-term viability of the auditing profession, outlined in a three-point plan that:

1. Assists the profession in becoming insurable
2. Clarifies PCAOB standards, including those related to internal control audits, and
3. Supports expansion and competition of the Big 4 firms.

Conclusions published in the Report follow:

a. Sarbanes-Oxley has greatly increased the role of auditing in public companies.

b. The pressure for auditors to do more when conducting audits means that the auditor-client relationship is becoming more involved and continuous, with much more frequent interactions, rather than simply holding periodic discussions.

c. The auditing profession faces a number of significant legal challenges:

1. Auditors continue to be the target of a difficult litigation and regulatory enforcement environment.

- Business losses by a client can result in lawsuits.
- A single indictment, even without a conviction, can result in the destruction of thousands of jobs, such as in the case with Arthur Andersen.
- Over-litigation and unfair enforcement are so dire that the profession is essentially uninsurable.
- Because of the personal financial risk of being an auditor, it is becoming increasingly difficult to attract and retain high-quality personnel to the profession.
- Audit firms feel they are caught in the middle between the demands of regulators, law enforcement, the plaintiff's bar, and their clients.

2. The process of developing and interpreting accounting principles remains in flux as business transactions become more complex.

- There remains significant misunderstanding about the meaning and nature of accounting principles which can translate into significant litigation risk.

- Changes of one or two cents per share may drive a litigation claim even though such changes indicate nothing about the financial health of the company's underlying business.

3. The accounting profession is severely contracted, with only four major accounting firms serving a large majority of the listed and actively traded public companies in the United States.

- Any further contraction in the accounting industry would present a major challenge to the viability of the profession.

Recommendations made by the Chamber of Commerce:

In its Report, the Chamber of Commerce recommended that the following actions be taken to save the audit profession.

1. Help the profession become insurable

a. Better define auditor procedures and responsibility for fraud detection and limit the auditor's responsibility to it.

- Develop a *safe harbor standard* for fraud detection that clearly defines the nature and extent of procedures an auditing firm must perform to detect fraud.

- The safe harbor would be developed and approved by both the PCAOB (for public companies) and the ASB for nonpublic entities.

- Firms that perform under the safe harbor would be protected against legal liability.

b. Create an Alternative Dispute Resolution (ADR) system for disputes about audits.

- Juries and non-expert judges cannot properly evaluate arcane accounting judgments and auditing methodologies.

- A specialized accounting court could also be considered as part of the ADR system.

c. Permit parties to agree to ADR and reasonable limits on litigation.

- The SEC and banking regulators need to accept the ability of auditors and their clients to agree to limitations on damages and indemnification provisions.

d. Regulate threats of indictment against audit firms.

- The inappropriate indictment of Andersen led directly to the loss of 28,000 jobs in the United States and more than 80,000 worldwide, even though the indictment was subsequently withdrawn.

- Criminal indictments should be made against the individuals involved in the purported crime and not the firm as a whole.

- Individuals within the firm who had no knowledge of the criminal activity should not be punished.

- Congress needs to reign in the Justice Department and other regulatory authorities and establish clear rules under which firms may be criminally indicted.

- Firms need a chance to be heard before indictments are issued.

2. Clarify PCAOB standards

a. The PCAOB has created the environment for overauditing and has the responsibility to clarify its standards and provide safe harbors for auditors allowing them some measure of predictability and freedom from being second guessed.

Example: Previously, the PCAOB issued PCAOB Standard No. 2 (as superseded by PCAOB Standard No. 5), as the primary implementation standard for Section 404 of Sarbanes. PCAOB Standard No. 2 was considered too broad, and principles-based. PCAOB Standard No. 2 also used broad terms as "significant" and "relevant" which needed more explanation. Consequently, auditors were "overauditing" their clients. Ultimately, the PCAOB issued PCAOB Standard No. 5, which superseded PCAOB No. 2 and simplified and clarified the requirements for auditors to deal with Section 404 of Sarbanes Oxley.

3. Support expansion and competition among top-tier firms

a. The SEC should reexamine regulations that prohibit the Big Four firms from competing for audit assignments when they have performed disqualifying services in prior years.

b. Remove nonmarket barriers that impede competition with the Big Four.

- The SEC and PCAOB, among others, should support policies that help the entire profession become insurable since risk management is a huge barrier to growth for any firm seeking to audit public company clients.
- Clarify and streamline the accounting standards to make it less expensive for firms to stay current with the latest pronouncements.

- The FASB needs to address the problem of infinite complication in accounting rules, which makes it almost impossible for even the most knowledgeable and well-intentioned accountants to keep up.

- SEC needs to include non-Big Four firms in the GAAP debate.

- All parties should encourage public companies to consider high-quality firms outside the Big Four by encouraging Wall Street underwriters and the investing public to accept other choices such as those in the second-tier of national or regional firms.

Can there ever be a Big Five accounting firm?

Although the Chamber of Commerce report has merit, the third recommendation, of creating competition to expand the Big Four, is least likely to happen. Two reports reach the same conclusion; that is, it is virtually impossible to create a fifth national firm the size of the Big Four.

In a GAO report published entitled, *Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action* (the Report), the Report reached several conclusions as to the concentration of the Big Four firms and whether action should be taken to increase concentration among them.

1. The Big Four audit more than 98 percent of all U.S. public companies with more than $1 billion of sales.

   - Midsize and smaller firms audit approximately 80 percent of the smallest public companies with sales of less than $100 million.

2. Internationally, the Big 4 dominate the market for audit services.

3. Only 40 percent of large companies noted that the number of accounting firms from which they could choose was adequate.

   - In contrast, 75 percent of the smallest public companies stated their number of audit choices was sufficient.

4. 90 percent of large public companies stated they would not use a non Big-Four firm. Reasons noted included:

   - There is lack of capacity for non Big-Four firms to perform the audit.

   - Selecting a Big Four auditor is a prudent and safe move.

   - There is a reputational requirement of using the Big Four by shareholders, banks, lenders, and underwriters

5. More than 70 percent of midsize and smaller accounting firms have no interest in obtaining large public company audits.

6. There is no evidence that the market concentration among the Big Four has any bearing on the significant increase in audit fees in the post-Sarbanes era: Other factors were noted as causing the increase in fees including:

   - Increased complexity of accounting and financial reporting standards that has driven a greater need for technical expertise.

   - Additional auditing standards that have increased the amount of work required

   - Additional work required to prepare for PCAOB inspections.

   - Additional work to comply with Sarbanes-Oxley and Section 404 requirements.

7. Because of the barriers to entry, market forces are not likely to result in the expansion of the current Big Four. Smaller accounting firms face significant barriers to entry into the audit market for large multinational public companies for several reasons including:

   - Smaller firms generally lack the staff, technical expertise, and global reach to audit large and complex national and multinational public companies.

   - The Big Four had more than five times as many partners and over seven times as many staff as the average for the next four largest firms.

	Big Four	Next four largest firms (1)
Partners	8,487	1,588
Professional staff	79,607	11,403
Offices	354	227
Public company clients	5677	919
(1): includes RSM (formerly McGladrey), Grant Thornton, BDO Source: GAO Report		

8. The results of a further concentration in the Big Four (down to Big Three) would significantly increase the concentration in the audit market. The Report cited several risks that could result in a loss of a Big Four firm including:

   - A sizeable civil litigation claim in excess of insurance coverage
   - Criminal prosecution, such as in the case of Arthur Andersen, and
   - A merger of two of the Big Four firms.

What would happen if a Big Four firm goes under?

In the report entitled *The Future of the Accounting Profession: Auditor Concentration*, participants were asked to assess the risks of reducing the Big Four to the Big Three due to the potential loss of one of the Big Four firms.

1. There was significant concern about the potential loss of another Big Four Firm.

   - The current degree of concentration raises the specter that the collapse of the Big Four firm would be a threat to the continued existence of the profession.

   - An environment with only three firms would be too small to maintain audit quality and independence, and would call into question the viability of the survivors.

2. The consequences of losing another member of the Big Four to civil or criminal litigation could potentially include the end of the public company audit profession and the takeover of that function by the Government.

   - Government taking over the audit process would lead to qualified professionals leaving the profession.

3. The greatest risk to the Big Four is the omnipresent threat of litigation and regulators must take immediate steps to address it:

   - Because the current pattern of litigation involves huge claims (e.g., one Big Four firm faced a damages claim of $12.4 billion), firms cannot take the risk of bringing the case to trial.

   - The real problem with litigation is that it increases transaction costs and results in difficult and complex accounting issues being presented to unsophisticated juries.

   - The tempo of litigation against accountants has picked up substantially with each of the Big Four having significant claims in excess of capital.

   - There is widespread agreement that the profession in the United States needs to move away from what is called a rules-based system to a principles-based one, which will lead to greater litigation against auditors.

   - Investors today are suing companies and their auditors for earnings downturns on a regular basis.

   - Audit partners are leaving the profession in fear of losing their personal assets.

4. There is a profound disconnect between investors' expectations and what an audit can actually accomplish, and the profession must reconcile the disconnect.

   - It is impossible for auditors to identify all problems, fraud, or account for all contingencies in the audited financial statements.

- Although auditors convey their limitations to audit committees and boards, they fail to communicate to the public thereby resulting in the expectation gap.

5. The Big Four are unable to obtain a comprehensive catastrophic risk insurance policy, thereby requiring them to self insure.

    - Because of the limitations on obtaining comprehensive insurance, the current LLP legal structure may not provide the Big Four with enough legal protection.

How bad are the litigation claims?

In 1995, Congress passed the *Private Securities Litigation Reform Act of 1995* (the Act). The Act was designed to curb previous abusive securities litigation, and provides requirements for companies and their auditors involved in securities including rules for:

1. Dealing with forward-looking statements including a safe harbor provision

2. Filing complaints for securities fraud including class action claims

3. An approach for quantifying damages under a litigation claim, including determining proportionate liability

4. Mandatory sanction provision, and

5. Specific requirements for outside auditors including procedures designed to provide reasonable assurance of detecting illegal acts that would have a material effect on the financial statements, identify related party transactions, and evaluating going concern.

n April 2016, Cornerstone Research issued two annual reports; one entitled *Accounting Class Action Filings and Settlements- 2015 Review and Analysis*, and the other, *Securities Class Action Settlements, 2015 Review and Analysis.* The reports confirm that a litigious environment exists that represents dire risk to any one of the Big Four accounting firms, or any other firms that audit SEC companies.

Consider the following statistics from the two Cornerstone reports:

a. Accounting cases represented *38% of all cases filed in 2015*, slightly down from 41% in 2014 and up from 28% in 2013.

b. Those same accounting cases represented *87% of total settlement dollars* in 2015 for all cases that were settled in 2015 (up from 85% in 2014).

c. In 2015, the average settlement for accounting-related cases was higher than for non-accounting cases.

Accountant's Involvement	Average settlement

Involving accounting issues	$53 million
Involving non-accounting issues	913 million

d. Accountants and auditors were named in 35% of the accounting-related cases in 2015, a 50% increase over the average for the ten prior-year average.

The median settlement increased if the accountant was named as a defendant in the lawsuit.

Settlement as % of damages claimed:

Accountant is named defendant	3.7%
Accountant is not named as defendant	32.9%

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e. For the four consecutive year, the majority of new accounting cases filed included financial statement restatement and internal control weaknesses.

ef. Cases involving accountants (as compared with non-accounting cases) are:

- Less likely to be dismissed
- Far more complex
- Take longer to resolve, and
- More costly to defend.

fg. GAAP allegations that involve a financial statement restatement and/or accounting irregularity are the highest settlement amounts in relation to shareholder losses.

Amount as a Percentage of Damages Claim

Accounting Issue	**Median settlement amount**	**Median estimated damages-lawsuit**	**Median settlement amount as % of estimated damages claim**
Accounting irregularity	$2.2 million	$190 million	1.1%
Restatement	13.0 million	4248 million	21.2%
Writedown	119.5 million	8864 million	12.3%

Cornerstone, *Accounting Class Action Filings and Settlements- 2015 Review and Analysis,* April 2016

Observation: Although the median settlement amount ranged from 1.1% to 2.3% of the median damages filed in the lawsuit, the risk that the accountant will lose the case forces the firm to settle the case. The fact is that most larger, national CPA firms (including the Big 4) self insure a portion of their malpractice insurance. That means that if a case were to go to trial and the firm lost, the firm could be exposed to having to pay $300 million to $700 million in damages. Note further that the numbers in the previous table represent median amounts. In 2015, there were suits filed against Big 4 firms that had individual claim amounts in excess of $2 billion. If the firm were to lose such a case, the firm would not be able to pay out a $2 billion judgment. Therefore, accounting firms are very motivated to settle cases as they cannot take the risk that they lose the case.

Simply put, if a plaintiff wants to get its highest settlement amount, the plaintiff should name the accountant/auditor as a defendant and make sure the claim is for several billion dollars. In most cases, the accountant has no choice but the settle or run the risk of losing and going out of business.

In fact, not only are settlements higher when the accountant/auditor is named as a defendant, but other factors result in higher settlement amounts.

Settlements are higher when the following factors exist:

- There are high estimated damages
- There is a higher defendant asset size
- There has been a restatement or corresponding SEC action
- ***An accountant is named as a co-defendant***
- An underwriter is named as co-defendant
- There is a corresponding derivative action
- An institution is a lead plaintiff
- There is a restatement of financial statements
- There is a derivative involved in the claim
- There is also an SEC action against the defendant
- A public pension fund is the plaintiff

gh.Top cited accounting issues in lawsuits include:

- Estimates
- Overstated assets
- Understated liabilities and expenses
- Revenue recognition

II. The Viability of the Big Four

Since the demise of Arthur Andersen, there have been numerous reports and recommendations issued to address the Big Four and what many consider to be a risky and unhealthy concentration among the Big Four accounting firms.

The Big Four, along with two second-tier firms, issued a report entitled, *Serving Global Capital Markets and the Global Economy*.

The Report is written with a focus on changes to global financial reporting and public company audit procedures that need to adapt to those changes.

Recommendations made by the Report include:

a. The world's accounting and auditing standards must be harmonized and based on a principles-based system rather than a rules-based one.

- The World's financial transactions are far too complex to account for under a rules-based system.

- If there is a convergence toward one set of Global standards, that set should be very close to those principles-based standards dictated by the International Financial Reporting Standards (IFRS).

b. Auditing standards should be established at the international level in lieu of the PCAOB.

- One set of global auditing standards would provide global markets and other stakeholders the same quality of audits regardless of where they are conducted.

c. There should be one set of global enforcement and governing rules for auditors including those related to independence.

d. Address the expectation gap regarding fraud detection.

- There are inherent limits as to what fraud auditors can reasonably uncover in an audit yet many investors, policy makers and the media believe that the auditor's main function is to detect all fraud. When fraud materializes and the auditor did not find it, the auditors are presumed to be at fault.

- There needs to be a constructive dialogue among investors, other stakeholders, policy makers and auditors as to what can be done to both narrow the expectation gap and enhance fraud detection. Ideas for fraud detection include:

  1) Subject all public companies to a forensic audit on a regular basis (e.g., every three or five years) and/or on a random basis.

  2) Let shareholders decide the intensity of the fraud detection effort they want their auditors to perform.

e. Enable networks to integrate further to strengthen audit quality.

- The quality of the audit may be enhanced if the Big Four were able to be structured as one single global operation instead of a network of segments of the firm.

- The current environment limits an audit firm ownership in some countries which require all owners or partners of the firm conducting audits in a jurisdiction to be licensed to practice in that jurisdiction.

- Some countries, including the United States, discourage national firms and their partners or members from being part of a single legal enterprise.

f.Address the concentration in the audit profession.

- The global enforcement markets recognize that the loss of another major audit firm would have a significant impact on the capital markets.

- In order for there to be alternatives to the Big Four, the market must lower the risks within the profession so that networks will make the investment needed to serve the very largest of companies.

- Enforcement authorities must focus penalties for any auditor wrongdoing or negligence on those directly implicated in such activities, rather than on the entire firm that employs them.

- There needs to be liability reform that limits audit firms' exposure to liability so that all firms, even smaller ones, would be willing to take on larger company audit assignments.

- The national governments need to relax the non-attest services performance restrictions for auditors so that there is a greater choice of auditors.

g.Change the financial reporting model.

- A new financial reporting model should be driven by the wants of investors and other users of the financial information.

- Securities regulations should be changed so that financial and non-financial information is reported in real-time over the Internet.

- Information should be forward-looking even though it may be historical in fact.

- Non-financial drivers should include disclosure of measures that include customer satisfaction, product or service defects and awards, and employee satisfaction.

h. The audit industry should be permitted to offer consulting and tax advice to their audit clients so that those firms can attract and retain individuals with the necessary skills and talent to service the profession.

Observation: The markets have looked upon the Big Four report with mixed views. Some commentators consider the suggestions to be self-serving that will result in expanded future business for the national firms. Others consider the report to be forward looking and an essential basis for reinventing the accounting profession.

Report of the Advisory Committee on the Auditing Profession to the U. S. Department of the Treasury

Previously, the U.S. Department of Treasury established an Advisory Committee on the Auditing Profession to deal with the various issues facing firms that audit public companies including the condition, sustainability and future of the auditing profession in light of the fact that the Big Four audit 98 percent of all public companies.

A report entitled *Report of the Advisory Committee on the Auditing Profession to the U. S. Department of the Treasury*, was issued by an Advisory Committee, the purpose of which is to provide recommendations to enhance the sustainability of a strong public company auditing profession.

The Report made the following observations which are still relevant today:

a. Litigation-related expenses are a significant component of auditing firms' cost structures but are not at a level that significantly affects their ability to recruit talent or grow their practices.

b. Audits of large public companies are concentrated among a limited number of auditing firms and the largest of these firms are not able to use third-party insurance in a cost-effective manner to manage their litigation costs.

c. The largest U.S. public companies have enormous market capitalization so that if a large cap company were to become insolvent or suffer a significant decline in value, such a market loss would often exceed the total capital of the auditing firm.

d. Auditing firms often feel pressure to settle mega or catastrophic claims even if they believe they have meritorious defenses due to the risk that a loss could threaten the firm's survival.

e. Auditing firms are also at risk for other claims against them including criminal indictment that could threaten survival.

The Report recommended the following changes be made, among many others noted with the Report:

1. Large auditing firms should issue audited financial statements to the PCAOB and should have audit committees.

2. There should be a move toward a national professional liability regime for public company auditing firms.

    - Auditing firms that are faced with litigation claims that threaten their survival should have reasonable opportunity to litigate and appeal such matters.

3. Congress should consider the creation of a federally chartered audit firm structure that would include limits on liability for audits of public companies, mandatory public reporting of audited financial statements, and required capitalization levels, among other requirements.

4. Because of the risk of loss of any of the Big Four firms, the PCAOB should monitor auditor conduct that might present a risk to sustainability of any of the Big Four auditing firms.

bservation: From the tone of the Report, it appears that in order for the Big Four to get some form of limited liability protection from claims, those firms will have to provide greater transparency in terms of the firms' operations and profitability. Query whether that is an acceptable tradeoff.

The current risky environment for the Big Four

One report indicates that the six largest auditing firms (the Big 4 plus Grant Thornton and BDO Seidman) are defendants in close to one hundred private actions related to audits of both public and private companies (either shareholder class actions or actions brought by companies or bankruptcy trustees) with damage claims against the auditors in each case in excess of $100 million.[3]

- Forty-one of the ninety cases seek damages in excess of $500 million.
- Twenty-seven cases seek damages in excess of $1 billion, and
- Seven cases seek damages over $10 billion.

In looking at the high percentage of claims that exceed $1 billion, the Big Four are one large lawsuit away from becoming the Big Three, or Big Two. The highly aggressive litigious environment coupled with a lack of liability caps on lawsuits, exposes any one of the Big Four to the risk that a huge litigation claim puts them out of business.

Grant Thornton and others have stated that the current audit market is unsustainable and that new rules must be created to develop greater competition. In its letter, Grant Thornton

[3] Treasury Advisory Committee on the Auditing Profession, Final Report

noted that in the event of the demise of any one of the Big Four, 20 percent of the 7,200 largest businesses in the G20 would be left without an auditor.[4]

In general, it is unlikely that any one of the Big Four could sustain a litigation claim in the $1-2 billion range.

The latest example of a single lawsuit that can bring down one of the Big Four is the series of lawsuits that are pending against several of the Big Four and other CPA firms involved in the Madoff scandal. Previously in this course, the auditor discussed the litigation that continues against many of the auditors of the feeder funds that invested in Madoff's funds.

In general, each of these lawsuits were filed by feeder funds that were audited by the Big Four and that had money invested with Madoff.

For example:

- KPMG was sued for $3.3 billion by Tremont Group, a feeder fund invested with Madoff.
- PWC's United States, Bermuda, and U.K. are being sued by parties in connection with Fairfield Sentry, a feeder fund that had $7.2 billion of assets invested with Madoff.
- Ernst & Young was sued in Luxembourg by a group of investors involved in the LuxAlpha Fund that once had $1.4 billion invested with Madoff.

At the heart of most of these lawsuits is whether the auditor for the feeder fund had a responsibility to audit and verify the existence of the fund's assets invested with Madoff. None of the Big Four were Madoff's auditors.

In the PWC case, the plaintiffs alleged that PWC did meet with Madoff and accepted his assertions about the existence of funds without verifying the existence of the funds. PWC alleges that it had no responsibility to audit the underlying fund assets held by Madoff given the fact that PWC was not Madoff's auditor.

The plaintiffs also observed that PWC did nothing to investigate the credentials of the small audit firm, Friehling & Horowitz, that audited the Madoff funds.

Given the size of the lawsuits against the Big Four in the Madoff scandal, most, if not all of them, have been settled, as the Big Four cannot take the risk of losing any one of these multi-billion dollar claims.

The allegations made that the feeder fund auditor must look through and audit the underlying assets of the core fund (Madoff in this case) could have chilling effects on how investment funds get audited. Many auditors of feeder funds may be reluctant to audit the feeder fund unless they are also auditing the core investment fund.

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[4] Grant Thornton letter, as published in accountancyage.com.

How big would a claim against a Big Four firm have to be to put it out of business?

Because the Big Four firms self insure a large portion of their settlements, any one of the Big Four is at risk of being forced out of business due to one mega-claim coming to fruition.

The question is how large must a claim be to yield the lethal blow to a Big Four firm?

Recently, James Peterson, former inside counsel for Arthur Anderson, calculated how large a legal judgement, fine or settlement would have to be to cause a Big-Four firm failure.[5]

Peterson's model is based on an earlier report by consulting firm London Economics, which modeled the maximum threshold of a claim against any one of the Big Four-UK partnerships.

The model used is based on the following general assumptions:

a. If there is a large litigation result against a Big Four firm, that firm's viability would be exposed to the combined effects of a financial crisis environment, reputational pressure, and the hostile publicity from the adverse litigation result.

b. In a crisis environment, if there is a per-partner profit reduction of 15% to 20% that extends over three to four years, a critical number of partners would defect placing the firm in a death spiral.

c. U.S. practices of any one of the Big Four could sustain a claim *ranging from a high of $3.6 billion to as low as $900 million.* Any claim or series of claims in excess of this range would expose a Big Four firm to the risk of failure.

III. The Effect of Enron- 15 Years Later

22017 marks the 15-year anniversary of the demise of Enron and the issuance of the *Powers Report* that provided a detailed account of the reasons for Enron's demise.

Depending on who you speak with, Enron may go down in history as the single event that had the most impact on changing the accounting profession.

Now, more than a decade later, the question is whether Enron helped the profession, or did nothing more than create unnecessary administrative oversight and burden.

Let's look at some of the facts:

1. The demise of Enron resulted in a sizeable corporate economic failure that culminated in millions of dollars of lost investments, the unemployment of thousands of Enron employees, along with the dire loss of employee retirement funds that were invested in Enron stock.

[5] *The Financial Fragility of the Big Four Accounting Firms- Updating the "Tipping Point"* James Peterson

2. Top Enron executives went to prison including Andrew Fastow (CFO), Jeffrey Skilling (CEO) and Kenneth Lay (Chairman, who died before serving his prison sentence).

3. Arthur Anderson was charged with criminal obstruction of justice and went out of business, changing the Big Five to the Big Four [Anderson's obstruction charges were overturned in 2005].

4. Sarbanes-Oxley Act was passed in July 2002 and made sweeping changes to the accounting profession:

    a. Auditors were no longer permitted to perform certain nonattest and consulting services for their audit clients.

    b. Mandatory audit partner (not firm) rotation every five years was implemented.

    c. A new Public Company Accounting Oversight Board (PCAOB) was created to promulgate rules for public company auditors.

        - The accounting profession lost its right to self-regulation when the AICPA's Auditing Standards Board (ASB) lost the authority to issue auditing standards for public company auditors.

        - PCAOB was required to conduct regular peer reviews and inspections of public company auditors.

5. Audit committee and board rule changes:

    a. New standards were created for audit committees, requiring that companies assign at least one "financial expert" to the audit committee, among other changes.

    b. New conflict of interest rules were created to ensure that board members could not profit from other transactions with the company for which the board served.

    c. The audit committee was put in charge of hiring the auditor and negotiating the audit fees, taking away that activity from management.

6. A new whistle-blower program was created.

7. Section 404 of Sarbanes Oxley required companies to assess their internal controls and have their accountants report on such controls.

8. Section 302 of Sarbanes Oxley required the CEO and CFO to sign off on company financial statements.

9. Sarbanes Oxley introduced a series of criminal penalties for financial fraud, with a maximum prison term of 20 years.

10. Sarbanes introduced a Section 304 clawback provision, requiring a CEO or CFO to reimburse a company for any bonus or other incentive-based or equity-based compensation received during the 12-month period following a restatement due to a material noncompliance.

11. FASB issued an entire series of new standards to deal with better transparency and off-balance sheet transactions:

12. Sarbanes required the SEC to study whether a principles-based accounting system should be used for U.S. GAAP.

Sarbanes Oxley push to record and disclose off-balance sheet transactions

Perhaps no section of Sarbanes Oxley has had a more significant effect on all CPAs and their companies than Section 401 of Sarbanes Oxley.

Section 401(c) of Sarbanes Oxley required the SEC to complete a study of off-balance sheet transactions and related disclosures to determine:

a. The extent of off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities, including an estimated amount of off-balance sheet transactions, and

b. Whether GAAP results in financial statements reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion.

In 2005, the SEC performed an exhaustive study of off-balance sheet transactions that resulted in the issuance of their report entitled: *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers.*

That report, coupled with other pressures on the FASB, has resulted in the FASB taking aggressive action to issue various pronouncements that have resulted, or will result, in transactions being recorded on the balance sheet, even though not previously recorded.

Following is a list of pronouncements that the FASB has issued since the passage of Sarbanes-Oxley Act, and several pending projects:

Some Key FASB Pronouncements Post-Sarbanes Oxley Act		
Pronouncement Issue	**What it Does**	**Estimated Increase in Liabilities for SEC Companies**
ISSUED		
FIN 45: Guarantor's Accounting and Disclosure Requirements for Guarantees	Requires the recognition of liabilities for obligations undertaken upon issuing certain guarantees, as well as other disclosures	$125 billion
FIN 46R: Consolidation of Variable Interest Entities	Requires consolidation of certain variable interest entities as opposed to an approach based on control by ownership or legal authority	$444 billion
Share-Based Payment, SFAS No. 123(R)	Requires a fair-value based method of accounting for stock options and other equity instruments used to purchase goods and services, including employee services, eliminating the previous accounting guidance that allowed compensation paid in a particular form to go unreported in the financial statements. (2)	Not available
FASB No. 132: Disclosures About Pensions and Other Postretirement Plan Assets	Expands employers' disclosures about pension plans and other post-retirement benefit plans	NA
FASB No. 150: Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equities	equires a company both liabilities and equity	Not available
FASB No. 158: **Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans**	Requires an entity to record the funded status of a defined benefit pension plan on its balance sheet	$400 to $500 billion
ASU 2013-04: Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date	Provides rules for companies to measure and record joint and several liability arrangements.	Not available

ASU 2013-03: Leases	Records most lease assets and liabilities	$1.25 trillion

PENDING		
Other Contractual Obligations, Including Purchase Commitments	Goal to record various contractual commitments as liabilities instead of merely disclosing them	$725 billion
Fair Value Accounting	Goal to record all financial assets and liabilities at fair value	TBD

1. er the SEC Report, the estimate of total exposure is about $46 trillion, of which only $125 billion is recorded as liabilities.

2. The FASB's issuance of FASB No. 123R was not directly influenced by Sarbanes Oxley or the SEC.

Note: The estimated liabilities in this chart reflect only public companies as published by the SEC. There are trillions of dollars more in liabilities that have or will be recorded by non-public companies, the exact amount of which is not available.

In looking in the list, trillions of dollars of liabilities have already been brought onto balances sheets with an additional couple of trillion more, once lease changes are made.

Has Enron resulted in any good changes to the accounting profession?

The primary impact of Enron was the passage of Sarbanes-Oxley. Although many commentators believe that Sarbanes has placed undue procedures and cost on companies, many third parties believe that Sarbanes has had some positive results:

The good changes:

- Now that Section 404 compliance has been implemented by SEC companies, many of those same companies believe that it has resulted in companies cleaning up glaring weaknesses in internal control.

  Note: Although in the early years, the cost to implement Section 404 increased total audit costs by 40 to 60 percent, now most companies have noted that those costs have come down considerably.

- Financial statement restatements have come down in 2010 through 2015, from a peak in 2005.

- Auditors are now hired by the audit committee and not by company management.

- There is now a considerable separation between non-attest consulting and audit services within the same firms.

Now the bad:

- FASB standards have expanded considerably, placing a huge burden on all companies, particularly non-public companies, such as consolidation of variable interest entities (VIEs) and pension rules.

- Sarbanes changes have trickled down to expansive issuance of auditing standards by the Auditing Standards Board, applicable to non-public company auditors.

- Despite all the additional work required by Sarbanes, it failed to prevent the financial crisis during 2008 and 2009.

- The SEC has been overzealous in applying the clawback provisions of Section 304 of Sarbanes to executives, including those that were not responsible for the underlying restatement.

- Detection of fraud has not improved in the post-Enron environment.

- The Justice Department filing criminal charges against Arthur Anderson created the Big Four and a very tight pool of large audit firms capable of auditing large, multi-national companies.

IV. Going Concern Issues

For years, the rules for going concern have been found in auditing literature within AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (formerly SAS No. 59), which *requires an auditor to assess* whether an entity has the ability to continue as a going concern for a reasonable period of time (usually one year from the balance sheet date.) Because going concern is a GAAP issue, it belongs within accounting literature, in addition to auditing standards.

Background- Going Concern in Auditing Literature

In December 2016, Audit Analytics issued a report in which it performed a 16-year study of going-concern opinions.

The report, which samples financial statements through 2015, identifies the following trends:

1. 2015 going-concern report modifications were at the lowest level over a 16-year period.

Year	Going-concern opinions
2015	2,016
2014	2,230
2013	2,425
2012	2,570
2011	2,671
2010	2,988
2009	3,103
2008	3,354

Source: Audit Analytics

2. 15.1% of auditor opinions filed in 2015 contained a going-concern report modification. [The highest percentage was 21.1% in 2008, and lowest was 14.2% in 2000.]

3. Going-concern report modifications peaked at 3,352 in 2008 and dropped to 2,016 in 2015.

What percentage of companies recover from a going-concern report modification?

Interestingly, only a small percentage (ranging from 5 to 9%) of companies that had going concern report modifications rebounded with a clean opinion in the subsequent year.

The following table shows the details:

Number of Clean Opinions in Subsequent Year to Going-Concern Report Modification

Year	# going concerns prior year	# clean opinions current year, going concern prior year	% recovery in subsequent year
2015	2,230	123	5.5%
2014	2,425	200	8.3%
2013	2,570	188	7.3%
2012	2,671	144	5.4%
2011	2,988	208	7.0%
2010	3,103	276	8.9%
2009	3,354	265	7.9%
2008	3,309	200	6.0%
2007	2,878	253	8.8%

Observation: The previous table illustrates a key point with respect to going-concern report modifications. If such a report modification is made, it can be the "kiss of death" for a company in the subsequent years. A very low percentage of companies subsequently survive a going-concern report modification.

Does a going-concern report modification protect the auditor?

In 2012, Steven E. Kaplan and David D. Williams published the results of a study in a paper entitled: "*Do going-concern audit reports protect auditors from litigation? A simultaneous equations approach*." Their study was conducted to look at the issue of whether an auditor of a financially stressed entity reduces litigation risk by issuing a going-concern report modification.

The study reached the following conclusions:

a. Auditors make going-concern reporting decisions strategically, considering the litigation risk of their financially stressed clients.

b. Auditors use going-concern reporting as a preemptive action in response to elevated levels of litigation risk.

c. Issuing a going-concern report is associated with a *lower likelihood of being named in a class action lawsuit*. Investors consider the auditor's report when making litigation decisions for their financially stressed investments.

d. Going-concern reports *deter investors* from filing class action lawsuits against auditors.

Note: When investors see a going-concern report for financially stressed companies, they are apparently less likely to blame the auditor for their investment losses.

Issuing a going-concern report offers the auditor protection against claims of negligence due to reporting, but not other claims of auditor negligence. For example, a going- concern report is unlikely to deter investors from naming the auditor in a lawsuit in situations involving allegations of auditor negligence for fraudulent financial statements.

e. Issuing a going-concern audit report increases the likelihood of management-initiated auditor switches.

Is the language in the auditor's going-concern report modification effective?

Since the issuance of AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (formerly SAS No. 59), the going-concern report modification has come under scrutiny. In the early 2000s, criticism was placed on the auditing profession that too many companies that filed bankruptcy did not have a going- concern report modification issued prior to filing bankruptcy.

The language found in AU-C 570 is as follows:

Emphasis of Matter Regarding Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company's has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. 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 that matter.

Financial statement users continue to criticize the going concern report modification language for several reasons.[6]

1. The language used in AU-C 570 (formerly SAS 59) is vague, allowing for broad interpretation.

    - The terms *"substantial doubt" and "for a reasonable period of time"* are not clearly understood by third party users.

2. AU-C 570 places the responsibility for evaluating whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time squarely on the *auditor's shoulders and not management*.

    - The auditor is required to assess the effectiveness of management's plans for mitigating the going concern issue even though the auditor is not responsible for predicting future conditions or events.

    - Management is responsible for predicting future conditions or events, but management is not responsible for the going concern issue.

3. Investors and bankers complain that the current language found in the going-concern report modification causes alarm to the market and adversely affects the auditor:

    - The language in the going concern report modification creates *bad financial distress* and sends investors and bankers quickly running away.

4. The language in both the report and disclosure adversely affects the auditor.

    - The language leaves the auditor with either:

        1) a client with a recovery plan destined for failure, or

[6] *Going Concern: Where Is It Going?* Clemense Ehoff Jr., Central Washington University, USA Ahli Gray, Keiser University, USA, 2014

2) a client who is looking for another auditor willing to avert the going concern disclosure, commonly known as opinion shopping.

In either case, the auditor is faced with the risk of losing revenue if he or she inserts a going concern disclosure.

Note: AU-C 570 (formerly SAS No. 59) was supposed to be a warning sign for investors. Instead, it is often perceived as a "death sentence" for companies. The FASB's project on going concern requires management to evaluate going concern, thereby shifting some of the burden of evaluating going concern from the auditor to management (see further discussion further on in this section.)

Going Concern- GAAP versus Auditing Standards

FASB issues ASU 2014-15

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.*

ASC 205-40 provides guidance about management's responsibility to evaluate an entity's ability to continue as a going concern and to provide related disclosures. Previously, no such guidance existed in GAAP.

ASU 2014-15 is effective for the annual period *ending after December 15, 2016*, and for annual periods and interim periods thereafter. Early application is permitted.

The objective of ASU 2014-15 is to provide guidance for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern and about related footnote disclosures.

FASB ASC 205-40 does the following:

a. Requires management to make an evaluation of going concern every reporting period, including interim periods

b. Defines the term *substantial doubt about an entity's ability to continue as a going concern* (substantial doubt) as follows:

> "Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is *probable* that the entity will be unable to meet its obligations as they become *due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable*)."

Note: The term *probable* is used consistently with its use in Topic 450 on contingencies.

c. Provides that management should consider the mitigating effect of management's plans only to the extent it is *probable the plans will be effectively implemented* and mitigate the conditions or events giving rise to substantial doubt

d. Requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans

e. Requires an explicit statement in the notes that there is substantial doubt and other disclosures when substantial doubt is not alleviated, and

f. Requires an evaluation for a period *of one year after the date that the financial are issued (or available to be issued if a nonpublic entity*).

After the issuance of ASU 2014-15, there were certain inconsistencies between the GAAP and
auditing rules for dealing with going concern.

In particular, the one year period of time for evaluating going concern was different as follows:

a. AU-C 570 uses a *reasonable period of time* as the period for which an auditor should evaluate going concern. Generally, that period is one-year period from the balance sheet date

b. ASU 2014-015 uses a one-year period from the date the financial statements are issued or available to be issued.

In response, the Auditing Standards Board (ASB) issued an auditing interpretation in January 2015.

AU-C Section 9570: Auditing Interpretation: The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern: Auditing Interpretations of AU-C 570

In January 2015, the Auditing Standards Board (ASB) issued an interpretation to address conflicting issues related to GAAP's recently issues, ASU 2014-15, *Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* and, going concern rules found in AU-C 570.

The purpose of this interpretation is to clarify how AU-C 570's requirements for an auditor addressing going concern interrelates with the new GAAP rules found in ASU 2014-15.

1. Definition of Substantial Doubt About an Entity's Ability to Continue as a Going Concern

Question: AU-C section 570 refers to the term "substantial doubt about an entity's ability to continue as a going concern" but does not define it. For example, AU-C section 570 requires the auditor to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a *reasonable period of time*.

In applying AU-C section 570, how should an auditor apply the term substantial doubt about an entity's ability to continue as a going concern when the term is defined in the applicable financial reporting framework?

Interpretation: AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*, requires the auditor to form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. As a result, when the applicable financial reporting framework includes a definition of substantial doubt about an entity's ability to continue as a going concern, that definition would be used by the auditor when applying AU-C section 570.

For example, if an entity is required to comply with, or has elected to adopt, FASB ASC 205-40 early, the definition of substantial doubt about an entity's ability to continue as a going concern set out in FASB ASC 205-40 would be used by the auditor.

2. Definition of Reasonable Period of Time

Question: AU-C section 570 requires the auditor to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a *reasonable period of time*.

AU-C section 570 defines reasonable period of time as

> *a period of time not to exceed one year beyond the date of the financial statements being audited."*

How should an auditor apply this definition when the applicable financial reporting framework requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time greater than one year from the date of the financial statements?

Interpretation: As noted in Auditing Interpretation No. 1, *"Definition of Substantial Doubt About an Entity's Ability to Continue as a Going Concern,"* the auditor is required to form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

As a result, when the applicable financial reporting framework requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time greater than one year from the date of the financial statements, the auditor's assessment of management's *going concern evaluation would be for the same period of time as required by the applicable financial reporting framework* in forming an opinion on whether the financial statements are presented fairly, in all material respects, and determining whether an emphasis-of-matter paragraph is required. .

For example, if an entity is required to comply with, or has elected to adopt, FASB ASC 205-40 early, the auditor's assessment of management's going concern evaluation would need to be for the *same period of time as required by FASB ASC 205-40* (that is, *one year after the date that the financial statements are issued or available to be issued*) in forming an opinion on whether the financial statements are presented fairly, in all material respects, and determining whether an emphasis-of-matter paragraph is required.

3. Interim Financial Information

Question: AU-C section 930, *Interim Financial Information*, states that the objective of the auditor when performing an engagement to review interim financial information is to obtain a basis for reporting whether the auditor is aware of any material modifications that should be made to the interim financial information for it to be in accordance with the applicable financial reporting framework through performing limited procedures.

AU-C section 930 addresses the auditor's responsibility about when to make an inquiry concerning an entity's ability to continue as a going concern.

What are the auditor's responsibilities when the applicable financial reporting framework contains explicit requirements concerning management's responsibilities related to evaluating the entity's ability to continue as a going concern for interim financial information (for example, if an entity is required to comply with, or has elected to adopt, FASB ASC 205-40 early, management is required to comply with FASB ASC 205-40 when preparing interim financial information, including, when applicable, providing disclosures if substantial doubt about an entity's ability to continue as a going concern exists or has been alleviated)?

Interpretation: In accordance with AU-C section 930, if (a) conditions or events that may indicate substantial doubt about an entity's ability to continue as a going concern existed at the date of prior period financial statements, regardless of whether the substantial doubt was alleviated by the auditor's consideration of management's plans, or (b) in the course of performing review procedures on the current period interim financial information, the auditor becomes aware of conditions or events that might be indicative of the entity's possible inability to continue as a going concern, the auditor is required to

a. inquire of management about its plans for dealing with the adverse effects of the conditions and events, and

b. consider the adequacy of the disclosure about such matters in the interim financial information.

The consideration of the adequacy of management's disclosures about the entity's ability to continue as a going concern in the interim financial information includes a consideration of whether the entity's financial statements are presented in accordance with the applicable financial reporting framework. As a result, when the applicable financial reporting framework includes explicit requirements for management to evaluate the entity's ability to continue as a going concern

in preparing interim financial information, the auditor is required to perform interim review procedures related to management's evaluation of the entity's ability to continue as a going concern and the adequacy of the related disclosures in the interim financial information.

4. Consideration of Financial Statements Effects

Question: AU-C section 570 establishes requirements for the auditor to consider the possible effects on the financial statements and the adequacy of the related disclosure in substantial doubt has been alleviated after consideration of management's plans. In addition, in assessing the adequacy of the disclosures, the related application guidance in AU-C section 570 provides examples of matters that management might disclose in the financial statements.

How should an auditor apply this guidance when the applicable financial reporting framework contains disclosure requirements related to management's going concern evaluation? .

Interpretation: As noted in Auditing Interpretation No. 1, the auditor is required to form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

As a result, when the applicable financial reporting framework provides disclosure requirements related to management's evaluation of substantial doubt, the auditor's assessment of the financial statement effects under AU-C section 570 would be based on the disclosure requirements of the applicable financial reporting framework.

Observation: The auditing interpretation essentially states that in evaluating going concern, *an auditor should follow the same rules found in GAAP with respect to the period of time to which the evaluation should be applied*. That period of time is *one year from the date the financial statements are issued or available to be issued (if a nonpublic entity)*. Thus, the period of time that has been used for auditors previously (one year from the balance sheet date) is extended to be one year from the date the financial statements are either issued (public entities) or available to be issued (nonpublic entities). This change adds a few months to the going concern assessment period for an auditor. It also means that it is important that the auditor conclude his or her audit and ensure that the financial statements are issued so that the one-year period commences. The later the financial statements are issued, the later the one- year going-concern period is extended.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. In "*Auditing: A Profession at Risk*," which of the following recommendations was made by Chamber of Commerce to save the audit profession:
   a. Expand accounting rules and move toward a principles-based system
   b. Better define auditor procedures and responsibility for fraud detection
   c. Eliminate the use of an alternative dispute resolution system
   d. Expand the rules for Section 404 of Sarbanes-Oxley

2. According to the report, *The Future of the Accounting Profession: Auditor Concentration*, which of the following is <u>not</u> a factor contributing to the threat of litigation against Big Four auditors:
   a. Firms cannot take the risk of bringing a case to trial
   b. The increase in transaction costs with litigation
   c. Audit fees are not commensurate with the risk
   d. Investors are suing companies and their auditors for earnings downturns

3. Cornerstone Research reported that settlements are higher when which factor exists:
   a. Lower defendant asset size
   b. There has been no restatement
   c. A corresponding derivative action has been taken
   d. There is no co-defendant

4. Which recommendation was made in the Big Four report, *Serving Global Capital Markets and the Global Economy:*
   a. The PCAOB should establish auditing standards
   b. International standards should determine the effort level that auditors should expend in detecting fraud
   c. The Big Four should be able to work together further to strengthen audit quality
   d. The world's accounting and auditing standards should be rules-based

5. 5. Emily Melio is a CPA and is considering issuing a going concern report modification on Company X, an entity she is auditing. Which of the following is correct.
   a. If X following the typical trend, X should recover and have a clean opinion in the year following the going concern report modification
   b. X is not likely to have a clean opinion in the following year
   c. There is no correlation between the year of a going concern opinion and the subsequent year

d. X will be out of business within one year because that is precisely what a going concern opinion states will happen

SUGGESTED SOLUTIONS

1. In "Auditing: A Profession at Risk," which of the following recommendations was made by Chamber of Commerce to save the audit profession:
   a. Incorrect. The Chamber of Commerce made a recommendation that the FASB needs to address the problem of infinite complication in accounting rules, and not expansion of accounting rules. Nothing was mentioned about a principles-based system.
   b. Correct. The Chamber of Commerce did recommend that, to help the profession become insurable, auditor procedures and responsibility for fraud detection should be better defined and the auditor's responsibility to it should be limited.
   c. Incorrect. The Chamber of Commerce recommended that an alternative dispute resolution system should be created for dispute about audits to avoid litigation. Eliminating the resolution system was not mentioned making the answer incorrect.
   d. Incorrect. The Chamber of Commerce recommended that PCAOB standards be clarified and that Section 404 of Sarbanes-Oxley needed better explanation to save auditors from "overauditing" due to vague, nebulous guidance. Nothing was mentioned about expanding the rules for Section 404, making the answer incorrect.

2. According to the report, *The Future of the Accounting Profession: Auditor Concentration*, which of the following is <u>not</u> a factor contributing to the threat of litigation against Big Four auditors:
   a. Incorrect. One major problem with the Big Four going to trial is that they cannot take the risk that they lose, resulting in the demise of the firm. Thus the answer is correct.
   b. Incorrect. Because of the complexity of audit evidence, the costs of defending a lawsuit are significant, forcing auditors to settle, making the answer correct.
   c. Correct. There is no reference in the report to audit fees not being commensurate with the risk. Thus, the answer is not a factor.
   d. Incorrect. The report notes that investors are suing companies and their auditors for earnings downturns on a regular basis, thereby exposing auditors to extensive litigation risk. This answer represents one of the identified factors.

3. Cornerstone Research reported that settlements are higher when which factor exists:
   a. Incorrect. The report concluded that settlements are higher when the defendant asset size is higher, not lower. With higher assets, there is greater risk of loss thereby motivating settlement at a higher amount paid by the defendant.
   b. Incorrect. The report concluded that settlements are higher when there has been a restatement, and a corresponding SEC action. The reason appears to be because with the restatement, there is a claim that can be made by plaintiffs against the defendants.
   c. Correct. The report concluded that settlements are higher when there is a corresponding derivative action, which yields a higher overall risk.
   d. Incorrect. The report concluded that settlements are higher when there is either an accountant or an underwriter named as a co-defendant. The reason is because accountants and underwriters are more likely to quickly settle the case due to the risk of losing in court. The report does not reference that the settlements are higher when there is no co-defendant, making the answer incorrect.

4. Which recommendation was made in the Big Four report, *Serving Global Capital Markets and the Global Economy:*
   a. Incorrect. One of the Big Four's recommendations was that auditing standards should be established at the international level in lieu of the PCAOB.
   b. Incorrect. One of the Big Four's ideas for fraud detection was to let shareholders (not international standards) decide the intensity of the fraud detection effort they want their auditors to perform.
   c. Correct. One of the Big Four's recommendations was that networks of auditors should be established to further to strengthen audit quality. The report suggests that the current environment limits an audit firm's ownership in some countries which requires all owners or partners of the firm conducting audits in a jurisdiction to be licensed to practice in that jurisdiction.
   d. Incorrect. One of the Big Four's recommendations was that the world's accounting and auditing standards must be harmonized and based on a principles-based system rather than a rules-based one.

5. Emily Melio is a CPA and is considering issuing a going concern report modification on Company X, an entity she is auditing. Which of the following is correct.
   a. Incorrect. History suggests that X will not likely recover and have a clean opinion in the year following the going concern report modification. Only a small percentage of companies recover the next year with a clean opinion.
   b. Correct. Only about 5% to 9% have a clean opinion in the subsequent year making the answer correct.
   c. Incorrect. According to one study, there is a correlation between the year of a going concern opinion and the subsequent year in that only a small percentage of entities that have going concern opinions recover in the next year with a clean opinion.
   d. Incorrect. The opinion merely states there is substantial doubt that an entity will continue as a going concern. That language is certainly not absolute and does not state that the entity will be out of business within one year.

V. Retaliation Against Auditors Who Issue Adverse Opinions

Few audits result in the auditor issuing an adverse opinion. But when it happens, the question is whether the client retaliates by replacing the auditor the next year.

Although there is no study involving adverse opinions on financial statements, there is a study[7] that looks at the correlation between adverse auditors' opinions on a client's internal control over financial reporting (ICFR) as required by Section 404 of Sarbanes-Oxley.

Conclusions reached by the Study include:

a. Companies receiving adverse opinions on their ICFR are consistently more likely to dismiss their auditor in the following year.

    - An adverse ICFR opinion is the most consistently significant variable associated with dismissals in a four-year post-Sarbanes period.

b. Companies that dismiss their auditor after receiving an adverse ICFR opinion are more likely to hire a larger firm and industry specialist than companies that dismiss their auditor after receiving an unmodified opinion.

c. Companies that receive an adverse ICFR opinion switch auditors as part of an effort to improve their overall financial reporting quality, or as a signal of such activities.

Observation: The results of this study are no surprise. A company's management and board of directors/audit committee are in a difficult position when an adverse opinion is issued on ICFR or, for that matter, on its financial statements. In such a situation, the company has to take action to remedy the situation. One way is to change auditors and get a fresh perspective on the audit, suggesting that the previous auditor was somehow responsible for the deficiencies that lead to the adverse opinion in the first place.

VI. AICPA's Top Technology Initiatives

The AICPA has published its most recent *AICPA Top Technology Initiatives* based on a survey of its members. To no surprise, information security (securing the IT environment) and ensuring privacy are on the list along with data retention (managing and retaining data).

Following is the list:

- Securing the IT environment
- Managing and retaining data
- Managing IT risk and compliance

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[7] *Auditor Realignments Accompanying Implementation of SOX 404 ICFR Reporting Requirements*, Michael Ettredge et al.

- Ensuring privacy
- Enabling decision support and analytics
- Managing IT risk and compliance
- Preventing and responding to computer fraud
- Governing and managing IT investment
- Leveraging emerging technologies
- Managing vendors and service providers

VII. Anti Sarbanes-Oxley Continues After 15 Years

More than 15 years after the passage of Sarbanes-Oxley, third parties continue to evaluate whether Sarbanes has been effective in restoring public confidence in the financial markets.

Companies within and outside the United States complain about Sarbanes-Oxley. Although the merits of Sarbanes may have been positive in terms of cleaning up some of the abuses within public companies, the results have, in some cases, been extreme for several reasons. In particular, Section 404 internal control compliance requirements have been burdensome for most companies.

In one particular survey, one third of 186 executives of Fortune 1000 companies surveyed favor repeal of Sarbanes, while 94 percent of CEOs surveyed stated that the cost of Section 404 compliance exceeds its benefits.[8]

Additionally, one survey states that Sarbanes-Oxley has resulted in a $1.4 trillion (that's trillion) loss in stock-market value due to the demands of implementing and maintaining the Act's requirements.[9]

1. The cost of compliance is exceeding estimates, particularly the cost of the Section 404 certification of internal controls:[10]

Perhaps more has been written and promulgated about the Section 404 internal control reporting certifications than any other section of the Sarbanes-Oxley Act.

Section 404 of the Act requires the following:

a. *Section 404(a) of Sarbanes*: Management of a public company must assess the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

   1) Management must include in the company's annual report to shareholders, management's conclusion, as a result of its assessment, about whether the company's internal control is effective.

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[8] FEI Survey.
[9] *Economic Consequences of the Sarbanes-Oxley Act of 2002*, Xiying Zhang, University of Rochester.
[10] Surveys published by FEI and AMR.

b. *Section 404(b) of Sarbanes*: The company's auditor must evaluate management's assessment of internal control by taking certain steps that require the auditor to:

1) Perform a walkthrough of the company's significant processes.
2) Obtain evidence about the operating effectiveness of internal control for all relevant assertions and significant accounts or disclosures.
3) Test and evaluate the effectiveness of the design and operating effectiveness of internal controls.
4) Identify control deficiencies and categorize them into two categories:

   Significant deficiency: A deficiency that, by itself or in combination with other control deficiencies results in more than a remote likelihood that *a misstatement of a company's financial statements that is more than inconsequential*, will not be prevented or detected.

   Material weakness: A deficiency that, by itself or in combination with other control deficiencies, results in more than a remote likelihood that a *material misstatement* of a company's financial statements will not be prevented or detected.

c. The auditor must issue an opinion on the effectiveness of internal control over financial reporting, that is included in the company's published financial statements along with the audit report on those statements:

1) An auditor may express an unqualified opinion if the auditor has identified *no material weaknesses* in internal control.

   - An auditor is permitted to issue a *qualified or disclaimer opinion* if all the procedures considered necessary are not performed. If the overall opinion cannot be expressed, the reasons why should be disclosed.

2) The report may disclose *only material weaknesses* and *not significant deficiencies*.

   - An adverse opinion is required if one or more material weaknesses in internal control exists. The adverse opinion would apply to both management's assertion and the effectiveness of internal control over financial reporting.

What are the costs of Sarbanes-Oxley?

There have been numerous surveys conducted to determine the true cost of complying with Sarbanes-Oxley. In general, most studies evaluate the total cost as consisting of three components: a) audit fee, b) Section 404 compliance costs, and c) other internal/external costs of compliance.

Although external fees to outside auditors and consultants can be quantified, determining the internal costs can be difficult and distortive depending on what assumptions are made.

Here is what appears to be the best information on costs:

Estimated Cost of Sarbanes-Oxley Compliance

Market capitalization	Estimated total costs*
Less than $75 million	$850,000
$75 million to $699 million	2.5 million
$700 million or greater	5.5 million

* Consists of external audit costs, Section 404 costs, and other internal/external costs.

Source: *FEI Audit Fee Survey*

The cost of complying with Sarbanes Oxley has stabilized. This leveling off of costs suggests that the implementation issues of Sarbanes and Section 404 compliance have been worked through by the companies and their auditors.

Although overall Section 404 costs may have leveled off, total annual costs far exceed the amount that was estimated by the SEC at the inception of Sarbanes to be $91,000 per year for each public company. If one uses an assumed average annual estimated total cost of Sarbanes compliance of $4.0 million per public company and there are 18,000 public companies, the total annual cost of Sarbanes compliance is approximately $72 billion. Now, assuming Sarbanes has been in effect for 15 years (2003-2017), the estimated total cost of compliance, since inception, has been more than $1 trillion ($72 billion x 15 years). Of course, a portion of the Sarbanes costs consist of audit fees that the companies would incur anyway. Nevertheless, query whether the public receives anything close to $1 trillion of benefit from companies having to comply with Sarbanes-Oxley. Did Sarbanes protect the public from the Madoff scandal or the financial crisis with Lehman Brothers and AIG?

Dodd-Frank exempts smaller SEC companies from compliance with Section 404

Since the adoption of Sarbanes-Oxley in 2002, there has been criticism of the requirement for small issuers (market capitalization of $75 million or less (non-accelerated filers)) to comply with Section 404 of Sarbanes Oxley.

Section 989G of *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank) does the following:

a. It *exempts* non-accelerated filers (public companies with a market capitalization of $75 million or less) from having to comply with Section 404(b) (the auditor certification) of the Sarbanes-Oxley Act.

b. It also requires the SEC to conduct a study to determine how to reduce the burden of compliance with Section 404 for companies with capitalizations of between $75 million and $250 million. The SEC issued final rule 33-9142 that permanently exempts public companies with less than $75 million market capitalization from Section 404(b) internal control audit requirement.

Although smaller public companies are exempt from the auditor certification under Section 404(b) of Sarbanes (the auditor certification), small public companies ($75 million or less) would still have to comply with Section 404(a) which consists of the requirement that management assess the effectiveness of internal controls over financial reporting and include that assessment in the company's annual report.

The cost of audit fees

In general, audit fees have been very cyclical over the past decade. During the period 2003 to 2006, audit fees soared in the wake of Sarbanes Oxley and Section 404 compliance. From 2007 to 2010, audit fees declined each year and leveled off in 2010. Now, the most recent data indicates that audit fees for 2011 through 2015 rose at a far greater rate than previous years. Consider the following data based on a Financial Executives International (FEI) survey completed in 2016 for audit year 2015.[11]

1. Public companies:

   a. The average 2015 audit fee for the 89 public companies responding to a survey was $6.5 million, reflective of an:

      - Increase by 4.5% from 2014 to 2015

   b.Average relationship of a public company and its auditor was in excess of 20 years.

   c.91 percent of public companies used a Big Four firm.

2. Nonpublic companies:

   a.Average 2015 audit fees for nonpublic companies increased by 6.1% to $259,000.

   b.Average relationship of a nonpublic company and its auditor was about 8 years.

Why the increase in audit fees?

Over an extended period of time, audit fees for nonpublic entities have increased steadily at annual increases of less than 10 percent. For public entities, the increases have been far more volatile. In fact, 2015 represents the first year since 2011 in which public company audit fees increased at a rate of less than 10 percent. During 2012 through 2014, audit fees for public companies increased significantly before settling down in 2015.

[11] FEI Audit Fee Survey (2016)

Reasons cited for the increase in audit fees for public companies during 2012 to 2014 included:

- Increased requirements of work required by the PCAOB because of the board's criticisms of SEC auditors in PCAOB inspection reports
- Implementation of new PCAOB audit standards pertaining to risk, and
- The review of manual controls resulting from PCAOB inspections.

About one-third of public company survey respondents noted that the reasons for the audit fee increase in 2015 was due to an acquisition.

As for nonpublic entities, respondents explained that audit fees have increased from year to year due, in part to implementation of new accounting and auditing standards.

Does the market still punish companies that have restatements?

In the early 2000s, after Enron and other financial frauds, investors appeared less forgiving about earnings restatements. At that time, a restatement was considered a red flag for financial statement fraud, regardless of whether the restatement was a result of an intentional or an unintentional (voluntary) misstatement. There was evidence that suggested that the market had no tolerance for restatements and actually punished companies on both a short- and long-term basis, if they did issue restatements.

In one study, published by Min Wu of the New York University Stern School of Business,[13] the Study reached conclusions such as:

- A restatement is generally considered bad news by the market.
- The market reacts quite negatively to a restatement by penalizing the stock price for the three-day period after the restatement announcement.
- Restated companies lose credibility in the marketplace as investors rate their earnings as being a lower quality after the announcement is made.

Since the Min Wu Report was published, the market has become used to restatements with several years of significant restatements. The question is whether the market still punishes those companies that restate their financial statements, or has the market become exposed to "restatement fatigue."

One more study suggests that the public has not changed its reaction to restatements as follows:[14]

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[13] *A Review of Earnings Restatements* (Min Wu- New York University Stern School of Business).
[14] *Restatements: Investor Response and Firm Reporting Choices*, Plumlee and Lonbardi Yohn.

- The magnitude of the market reaction to restatement filings has not diminished with the increased frequency of restatements.

- How an entity discloses its restatement (with or without filing an 8K) suggests how the market will react to a restatement. Change in stock price and trading volume was significant if an entity filed an 8K versus if it did not.

Evidence also exists that the markets look upon material weaknesses unfavorably and can severely punish a company with a drop in its stock price for a 60-day period after the deficiency is announced.

Consider the following chart that illustrates this point:

Impact of Reported Weaknesses on Stock Price				
Type of deficiency	% Decline in Stock Price			
	Days after restatement filing			
	One day	7 days	30 days	60 days
All deficiencies	(.72%)	(.71%)	(1.35%)	(3.75%)
Material weakness:				
Financial systems/procedures	(.34%)	(.71%)	(1.35%)	(3.75%)
Insufficient accounting staffing	(.92%)	(1.19%)	(2.31%)	(4.80%)
Documentation	(.14%)	(.12%)	(.41%)	(5.29%)
Revenue recognition	(1.04%)	(.12%)	(.41%)	(5.29%)
Lease accounting	(1.39%)	(.71%)	(.13%)	(.86%)
Tax accounting	(.27%)	(1.20%)	(4.22%)	(5.77%)
Other	(2.59%)	(2.15%)	(.06%)	(3.31%)
All material weaknesses	(.67%)	(.90%)	(1.96%)	(4.06%)
Qualified opinion	(.23%)	(.66%)	(2.30%)	(3.56%)
Source: Glass Lewis & Co., FactSet				

Observation: The table data illustrates that the market is particularly sensitive to material weaknesses by punishing companies with a drop in market value of approximately 3 to 5% by 60 days after the deficiency announcement. Material weaknesses due to personnel issues, documentation, revenue recognition, and tax accounting have the most significant effect on stock price, all driving stock price down by approximately 5% by 60 days after the restatement announcement.

Based on the Glass Lewis information noted in the previous table, material weaknesses in internal control due to tax-related issues have yielded a 5.77% decline in the company's

stock value 60 days later. Clearly, that fact is an incentive to tighten up a tax department's internal control.

2. Companies have lost important advisors

One criticism of Sarbanes is that auditors are reluctant to give advice in fear that they may taint their independence. This cautious approach is resulting in criticism of the Big 4 by their clients. Specifically:

a. Companies are concerned that they no longer share strategies, ideas and proposals with their auditors, particularly those related to tax issues.

b. Companies can no longer consider the Big 4 as trusted advisors and are reluctant to ask them for advice.

c. There is more of an adversarial relationship between the auditors and their clients.

3. Some European companies are delisting from the U.S. exchanges:

There are approximately 470 non-U. S. companies listed on the NY Stock Exchange, with a combined market capitalization of $3.8 trillion, or 30% of the total exchange's capitalization. Many are questioning whether it makes sense to stay listed in the United States.

4. Smaller companies are fed up and going private:

The significant cost of complying with Sarbanes has resulted in many small companies going private and has held off several public offerings of small businesses.

According to a *Wall Street Journal* report,[15] more than 400 U.S. public companies have "deregistered" their stock and gone private since the effective date of Sarbanes Oxley. A survey of some of those companies suggests that many of the advantages of staying public no longer exist including:

a. *Access to public market capital is no longer important*: Private capital is abundant from sources including venture capital companies due to the availability of real-time information, investors can provide private capital to companies without the need of the public markets to monitor those companies.

b. *Smaller public companies do not benefit from the public markets like the larger companies do:* Larger companies such as General Electric and Microsoft benefit from the public markets through liquidity and coverage from analysts. Smaller to mid-sized companies do not receive the needed liquidity from the public markets as institutional investors ignore them, and analysts and banks do not give them adequate coverage due to lack of significant investment banking fees.

[15] As published in *So, Why Be Public?* (CFO)

c. *Private companies can now attract top executive talent as many CEOs and CFOs would prefer to work for a private company in the wake of the Sarbanes requirements:* Many CEOs and CFOs are concerned about the personal legal liability and risks to personal reputation associated with working for a public company. Consequently, those executives are attracted to opportunities within successful nonpublic companies where overall employment risk is lower.

d. *The direct and indirect costs of staying public exceed the benefits*: Both the financial and regulatory costs of staying public continue to increase with Sarbanes. Because most public investors do not understand the financial information they receive from public companies, they are more inclined to sue the companies upon being injured.

According to Grant Thornton, the number of U. S. public companies announcing privatization plans increased by more than 30 percent since Sarbanes-Oxley Act became effective.[16]

The typical small SEC company that has gone private over the past decade has the following profile:

a. A relatively small company with revenues around $80 million and a market capitalization of $40 million

b. Fairly inexpensive price per earnings ratio (5.5 times EBITDA)

c. A company in the consumer, information technology, or industrials sectors, and

d. An acquisition by management using private capital.

In an SEC report,[17] respondents were asked a series of questions related to Section 404 compliance. 69.7 percent stated that they somewhat or very seriously considered going private and 77 percent stated they considered delisting, due to Section 404.

These results are consistent with other surveys which demonstrate that smaller SEC companies are disenchanted with the additional compliance required by Sarbanes with particular frustration with Section 404 requirements.

What is the cost to stay public?

According to one study, the estimated total costs of a company with less than $1 billion of total sales staying public was $2.8 million and more than $11 million for a company with more than $1 billion of sales.

Key elements of total costs were audit fees and lost productivity from Sarbanes as summarized in the following chart:

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[16] *More Small to Mid-Size Public Companies Contemplating Going Private* (Grant Thornton)

[17] *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*, SEC

Costs of Staying Public

Type of Cost	Annual Sales Level	
	Under $1 billion	$1 billion or more
D&O insurance	$356,000	$1,820,000
Audit fee	1,184,000	5,800,000
Legal fees	200,000	226,000
Board fees	371,000	743,000
Lost productivity compensation	290,000	2,460,000
Other Sarbanes costs	177,000	222,000
Corporate governance set up costs	241,000	226,000
Estimated total costs	$2,819,000	$11,497,000

Source: *The Cost of Being Public in the Era of Sarbanes-Oxley*, Foley and Lardner, LLP

Observation: The table illustrates the significant cost of being a public company in the Sarbanes environment. Although overall Sarbanes-Oxley costs have leveled off, the total costs calls into question whether it is worth it to remain or become a public company.

For the smallest of public companies, those with annual sales of less than $250 million, the burden of staying public is greatest and disproportionate to sales. In particular, one study showed that the cost of complying with Section 404 costs a company with sales of less than $250 million, is disproportionately high at $1.56 million, while that cost increases to only $2.4 million for companies with sales in the $1 to $2 billion range.[18] Moreover, Dodd-Frank exempted smaller companies with less a market capitalization of $75 million or less from a portion of Section 404 compliance, but still leaves companies with greater than $75 million in capitalization with full Section 404 compliance. Unfortunately, for such smaller public companies, their full Sarbanes Oxley compliance costs are significant relative to sales. In fact, total Sarbanes Oxley compliance costs do not significantly increase when comparing total costs incurred by a smaller public company as compared with a larger one.

5. Board members are concerned about Sarbanes and now Dodd-Frank

If you were asked to become a member of the Board of Directors of an SEC company, would you? Would you accept a position on that company's audit committee?

Many existing board and audit committee members are asking this question in light of the changes made by the Sarbanes-Oxley Act. In the post-Act environment, serving as a board member or on a company's audit committee may not be worth it for several reasons:

[18] A.R.C. Morgan study

1. Under the Act, in the wake of the recent scandals, board and audit committee members are *required to spend much more time* in their capacity focusing on the new corporate governance rules and examining more data. Board members are *finding it difficult to find adequate time to serve on multiple boards* at the same time.

2. The Act *precludes* any board or audit committee member from receiving *any personal benefit* from the company that it serves. The days of receiving consulting fees or contracts from the company that is served are gone.

3. *Liability claims* against board and audit committee members have risen.

4. Additional travel requirements are playing a toll on board and committee members.

5. Directors and Officers (D&O) insurance coverage is lacking.

For some board and audit committee members, the additional effort and risk relative to the compensation is simply not worth it. Consequently, many companies are having trouble attracting the best and brightest to serve on their boards. In a recent *Wall Street Journal* article, one board member noted that he would spend an additional 100 to 200 hours per year (total of 300 hours) serving as a board member as compared with prior years.[19]

What is the basis for lawsuits against board members?

Under Sarbanes, lawsuits have focused on three sections of the Act, including:

Section 404: Directors' and officers' assessment of internal controls
Section 204: Auditor's reports to audit committees
Section 302: Corporate responsibility for financial reports

Observation: One particularly disturbing case related to Cray, Inc. Management notified the SEC that it uncovered material deficiencies in eight of its internal controls. Deloitte & Touche noted the material weaknesses in its Section 404 report. The shareholders filed a class-action lawsuit alleging that the audit committee violated sections of Sarbanes and that they knew about the problem and did not take action. The company's management denied wrongdoing in response to the suit.

What about D&O insurance?

> ***"I lie awake sleepless at night worried that I might lose my house due to some stupid class-action suit and there's not enough insurance to cover claims against the Board. Frankly, I would rather resign and play golf!"***

[19] *Meetings, Meetings, Meetings* (Wall Street Journal)

Worried Board Member of an SEC Company

In recent years, the scope of D&O insurance coverage has shrunk while its cost has risen. The greatest risk for board members is that a claim will not be covered by the D&O policy thereby exposing members to personal liability. This risk is real and has resulted in many qualified persons choosing not to accept positions on boards of public companies. One recruitment firm noted that close to *30 percent of 1,000 respondents to an annual directors' survey had turned down board member invitations as compared with only 13 percent in the pre-Sarbanes years*.[20]

One example was the settlement of WorldCom in which $55 million of claims were funded by only $35 million of D&O insurance coverage, leaving board members with $20 million of personal liability.

The result is that board members are paying more attention to the coverage found in the company's D&O policy.

Those looking into their D&O insurance coverage are startled by what they find:

1. No major insurance carrier offers compliance-specific insurance products such as those required by Sarbanes-Oxley's Section 404.

2. Some policies exclude coverage for negligent acts under Sarbanes while others include such coverage if there is a compliance-related claims coverage provision.

3. Some policies pay for compliance-related claims, such as those from Section 404, but do not include the SEC and other penalties and fines that relate from such claims.

4. Some policies cover claims initiated based on acts occurring during the covered period.

   Example: An act that occurs in 2015 and brought as a claim in 2017 might not be covered by a policy in effect for 2015.

5. Some policies include a "*defense allocation*" provision that allows the insurance company to pay only a portion of legal defense costs when a litigant alleges both covered and non-covered claims.

   a. In some cases, directors are required to spend their own money to pay for a portion of the legal bills in court cases.

In the post-Sarbanes era, the cost of D&O insurance increased right after Sarbanes-Oxley in 2002 and 2003, and then has decreased each year through 2013, leveling off in 2014 to 2017.

The risk of shortfall in D&O insurance

[20] Survey conducted by Korn/Ferry, a recruitment firm.

There are two types of D&O insurance: Side A which covers the directors and Side B which covers the company. Many companies increase Side A coverage because the company may not be able to indemnify the directors itself due to a lack of net assets or due to state law precluding companies from doing so. Additionally, if shareholders bring a suit against directors and officers on behalf of the company, the company is precluded from indemnifying the directors and officers for legal-defense costs. Thus, the directors get their own Side A insurance and the company pays the premium. According to one insurance company, only 9 percent of directors and officers received partial or no indemnification from their companies when charged in securities-litigation cases.[21]

What every director needs to know about the post-Sarbanes environment

The landscape for directors has changed over the past decade in the post-Sarbanes environment. Not only are directors having to invest more time into their duties, but they also face the unknown of having to be responsible for a set of confusing rules under Sarbanes-Oxley and now Dodd-Frank.

In one article entitled, *What Every Director Should Know About the New Environment*, the author makes the following observations about directors operating in today's business climate.

1. The Board's role in setting the tone for an organization's culture and its ethics has become increasingly more important.

2. With greater emphasis being placed on Sarbanes compliance, board members need to be concerned about applying a "check the box" approach and reading the rules too narrowly.

3. The courts, in particular those in Delaware, are now shaping a new set of rules defining the "*good-faith obligation*" of directors.

4. There are generally two parts to the good-faith obligation:

   a. Duty of *loyalty* and *care*.

5. Courts are looking at directors' behavior more closely than ever.

   a. Board members need to:

      - Come to board meetings prepared
      - Have thorough discussions in the boardroom
      - Ask hard questions of management
      - Apply sound judgment to make the right decisions.

6. Board members must be actively engaged to search for outside information about their company.

[21] Tillinghast Co.

Note: The courts are holding that simply relying on company-generated information is insufficient.

7. Board members need to be educated on important "hot" topics such as executive compensation, etc.

8. There is greater pressure being placed on ensuring there is a separation between the CEO and chairman of the board.

9. There is greater importance on boards establishing a strong succession plan for its CEO and other executives.

In an article entitled: *"Things to Do When Asked to Serve as a Director/Audit Committee Member (Besides Saying "No")*, the author provides some valuable insights into the future roles of audit committee and board members:

1. Audit committees bear increasingly greater responsibilities and public exposure these days, and committee members' duties are becoming more complex.

2. Audit committee members have greater exposure to litigation than board members, yet do not get paid as much or not at all.

3. Audit committees should take several actions to protect themselves:

    a. Always meet prior to each quarterly release to oversee the process.

    b. Make sure the audit committee and board are involved in reviewing the MD&A.

    c. Meet with the auditors.

4. Indemnification, exculpation and D&O insurance:

    a. Make sure that the company has adequate insurance and that the duties and functions are limited.

The challenges of the audit committee

A role of greater risk than serving on the company's board is serving on its audit committee. In fact, the role of the audit committee chairman is by far, the riskiest of all board members. Historically, in the pre-Sarbanes environment, the audit committee, in particular its chairman, was responsible for safeguarding the integrity of the company's financial controls and disclosures. Now, under the Sarbanes-Oxley Act, that responsibility has been enhanced with new corporate governance rules. In particular, audit committees must do the following:

a. Select and hire the external auditors
b. Review internal controls
c. Resolve accounting disputes and monitor disclosures
d. Select one audit committee member to be a designated "financial expert" who is familiar with GAAP.

Another study asked board members to identify those areas of concern. The respondents listed the following risks (other than financial risks) as being most important.

Type of risk	% Respondents
Regulatory compliance risk	68%
Reputational risk	54%
IT risk	33%
Product risk	32%
Fraud risk	27%

Concerns About Risks Confronting Boards, Eisner, LLP

6. The continued trickle-down effect of Sarbanes on nonpublic entities

When Sarbanes was adopted in 2002, the Congressional record stated that it was not intended to be applied to any organization other than public companies. Yet, the opposite effect is occurring.

As expected, Sarbanes has *indirectly* impacted accountants and auditors at various levels for several reasons:

a. There has been and continues to be a major increase in the number of new GAAP and GAAS statements being issued that apply to all entities, public and nonpublic, alike. For example, FIN 46R dealing with consolidation of variable interest entities is a direct result of requirements under Sarbanes Oxley focused on public companies.

b. Many states have adopted portions of the Sarbanes-Oxley Act in their accountancy acts with those provisions applying to all auditors, including those that audit nonpublic entities.

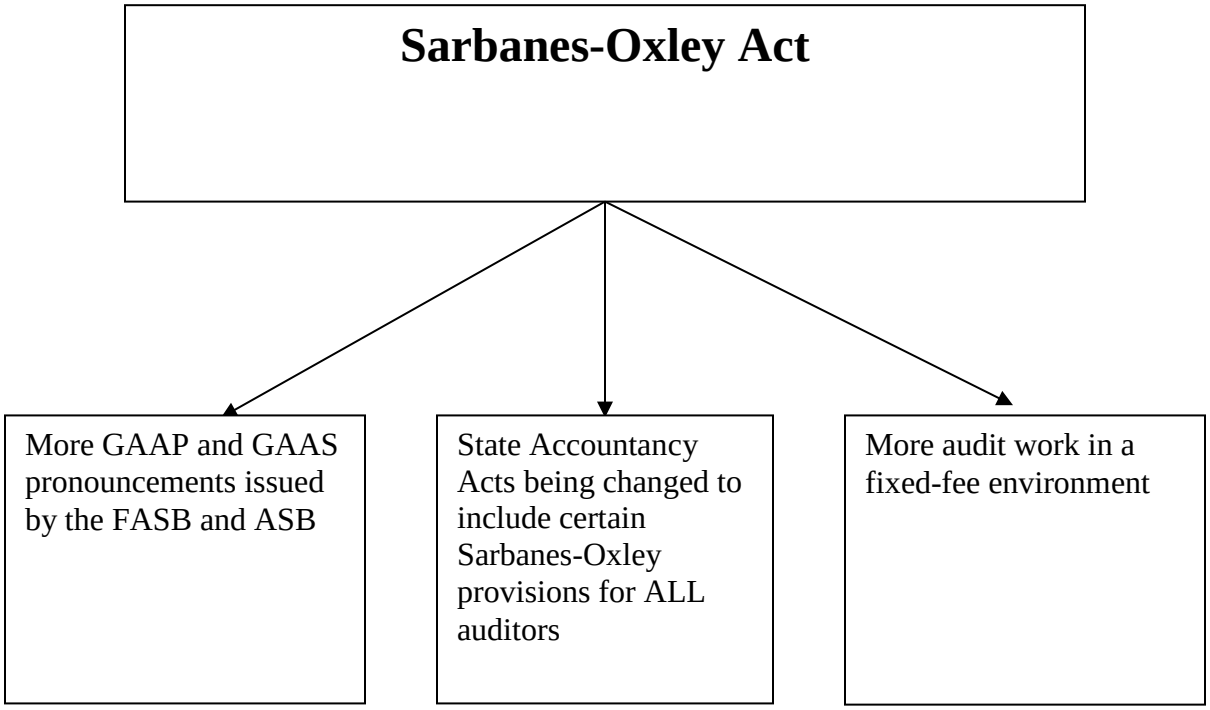
   1) Over the past decade, at least 25 states have passed some legislation that applies some portions of Sarbanes to nonpublic entities and their auditors.

   2) New York, California, Connecticut and New Jersey have been the most active in proposing or passing portions of Sarbanes for their states.

c. With the increase in audit and accounting rules, auditors continue to be required to perform more audit work the cost for which may be difficult to pass on to clients in fixed-fee engagements.

d. 87 percent of respondents to a survey felt that Sarbanes had impacted their organization. (97 percent of non-profits were impacted).

The Trickle-Down Effect of Sarbanes-Oxley to Auditors of Non-Public Companies



At the state level, several states have adopted portions of the Sarbanes-Oxley Act into their state accountancy acts. Although the Sarbanes-Oxley Act affects SEC auditors only, many states are applying its provisions across the board to all auditors, including those who audit nonpublic entities.

Many states have adopted several elements of Sarbanes applicable to all accountants and auditors, including those for private companies. Some state accountancy acts have been changed to do the following:

- Require a mandatory workpaper retention policy of seven years
- Have changed financial statement fraud from a misdemeanor to a felony
- Have changed the accountancy board makeup so that CPAs make up a minority of the board members
- Restrict accountants and auditors from performing certain nonattest work for their attest clients

In addition, the changes made by the PCAOB to auditing standards at the public company level, has resulted in a more aggressive Auditing Standards Board issuing numerous new auditing standards affecting nonpublic company auditors, such as the ASB's Clarity Project that resulted in the issuance of SAS Nos. 122-130.

The impact of Sarbanes on the Auditing Standards Board

Since 2003 and the passage of Sarbanes-Oxley Act, nonpublic auditors have seen in influx of additional auditing standards issued by the Auditing Standards Board (ASB). Remember, the ASB issues standards that only apply to nonpublic company auditors. Yet, clearly the ASB continues to be influenced by the actions of the PCAOB which issues standards for SEC auditors only. It is obvious that the ASB is gradually expanding auditing standards for nonpublic company auditors even though the overall quality of nonpublic company audits continue to be relatively high with minimal litigation issues in comparison to those issues found with SEC auditors.

In the post-Sarbanes era, the ASB has issued several significant groups of auditing standards that have expanded audit time for nonpublic company auditors.

Effective in 2006, the ASB issued the risk assessment standards found in SAS Nos. 104 to 111, which dramatically expanded the amount of work auditors have had to perform in planning and assessing risk in a financial statement audit. Most recently, the ASB has issued the Clarity Standards, SAS Nos. 122 to 130, which recodify previously issued auditing standards and expand overall audit work. There are numerous other standards all of which increase (rather than decrease) the amount of audit time. The ASB's direction of enhancing auditing standards for nonpublic company auditors is not likely to change in the near future.

Some private companies have voluntarily adopted some Sarbanes provisions

One survey suggested that some private companies have chosen to adopt certain segments of Sarbanes for various reasons. Some outside auditors, board members and third parties have put pressure on companies to adopt portions of Sarbanes.

Following is a summary of one survey noting the source of pressure on private companies to adopt certain provisions of Sarbanes:

Private Companies Adopting Provisions of Sarbanes: Sources of Pressure

Party	% of cases
Customers	14%
Lenders	13%
Insurance companies	5%
Investors	4%
Outside auditors	36%
Board members	46%
Self-imposed	70%

Source: *The Impact of Sarbanes-Oxley on Private & Nonprofit Companies,* Foley & Lardner LLP

Observation: The results of the survey illustrate that in one third approximately outside of the cases, the source auditors were private of pressure on adopt companies to Sarbanes. portions of

Another point made by the survey and not included on the above-noted table is that non-profits are more likely to voluntarily implement portions of Sarbanes (80%) as compared with private for-profit organizations (64%).

Which Sarbanes provisions have been adopted by private companies?

In general, private companies have adopted the *least expensive provisions of Sarbanes* which were estimated to be approximately $159,000 for for-profits and $104,000 for non-profit organizations. Few, however, have adopted the stringent Section 404 compliance requirements.

The most popular Sarbanes provisions adopted include:

Sarbanes Provisions Adopted by Private Companies	% respondents Implement
Audited financial statements	93%
Establish a corporate ethical code	88%
Disclosure of critical accounting policies and estimates	73%
Disclosures of off-balance sheet and contingent liabilities	81%
Establish independent directors	82%
Establish an audit committee	84%
Board approval of non-audit services	71%
Establish whistle-blower procedures	70%
CFO/CEO financial statement certification	59%

Note: The above percentages represent an entire pool of private companies surveyed. A closer look suggests that Sarbanes is more important to larger private companies ($300 million and more of sales) than smaller ones (less than $300 million). For example, 94 percent of larger private companies either have or plan to establish an independent board of directors while only 72 percent of smaller companies do.

Additionally, there has been more action to implement segments of Sarbanes among non-profits where there is a greater number of stakeholders.

7. CFOs want to change Sarbanes

CFOs and other financial executives were asked to respond to the following questions in a recent survey.

Which of the following statements about Sarbanes-Oxley are true for you?	
Complying with Sarbanes has made my job less satisfying	49%
Sarbanes has significantly increased my workload	75%
Sarbanes has made me consider a career outside of finance	16%
Sarbanes has elevated the stature of my job within the company	26%
Sarbanes will be good for my career	29%
None of the above	8%

If Congress were to revisit Sarbanes-Oxley, what three provisions would you like to see substantially revised or repeated?	
Section 404 internal control assessment	74%
Section 409 real-time issuer disclosures	43%
Section 201 limits on services audit partner can provide	41%
Section 203 audit-partner rotation	28%
Section 302 executive certification of financial reports	24%
Section 406 senior executive code of ethics	10%
Section 806 whistle-blower protection	10%
None	19%
How would you revise Section 201 limits on services audit partner can provide?	
Allow audit partners to provide a client with unlimited services	8%
Allow audit partners to provide some additional consulting services, but not tax	33%
Drop it	7%
Leave as is	48%
How would you revise Section 203 audit partner rotation every 5 or 7 years?	
Require audit-partner rotation later (such as every 10 years)	18%
Require audit partner rotation every 3 years	9%
Drop it	18%
Leave as is	57%
How would you revise Section 302 executive certification of Financial report?	
Lessen penalties for violations	8%
Require board members to also certify financial reports	15%
Allow executives to certify to best of knowledge and belief	55%
Have quarterly certifications apply only to charges in disclosure controls and procedures	26%
Drop it	2%
Leave as is	29%
How would you revise Section 404 and its related Auditing Standard No. 2?	
Require attestation/remediation of internal controls less often, such as every 3-5 years	46%
Allow for greater input from independent auditor before attestation phase	48%

Drop requirements that auditors review management's assessment of internal control	22%
Allow auditors to rely more on work of internal auditors	60%
Raise threshold of what constitutes a significant deficiency	70%
All costs of Section 404 to be capitalized	11%
Drop it	12%
Leave as is	5%
Would you favor or oppose a proposal to require the rotation of audit firms?	
Favor	20%
Oppose	64%
Not sure	15%
What one provision of Sarbanes has been the most beneficial to your company?	
Section 404 internal-control assessment	35%
Section 302 executive certification of financial reports	20%
Section 406 senior executive code of ethics	8%
Section 806 whistle blower protection	7%
Section 201 limits on services audit partner can provide	3%
Section 409 real-time issuer disclosures	3%
Section 203 audit-partner rotation	0%
None	23%
What one provision of Sarbanes has been the least beneficial to your company/ shareholders?	
Section 404 internal-control assessment	24%
Section 203 audit-partner rotation	22%
Section 201 limits on services audit partner can provide	12%
Section 409 real-time issuer disclosures	11%
None	11%
Section 806 whistle blower protection	8%
Section 302 executive certification of financial reports	6%
Section 406 senior executive code of ethics	5%
Do you think having to comply with Sarbanes has affected your company's earnings performance?	
Yes	67%
No	33%

If yes, by what percentage?	
All companies	(2.9%)
Companies under $500 million in revenue	(4.5%)
Companies with $500 million or more in revenues	(2.1%)
CFO Magazine survey of 237 financial executives	

VIII. The Impact of Dodd-Frank on Auditors into 2017

More than six years ago, then President Obama signed into law the *Dodd-Frank Wall Street Reform and Consumer Protection Act.* At its inception, the two primary goals of Dodd-Frank were to lower the systemic risks to the financial system and enhance consumer protections.

Dodd-Frank continues to make monumental changes to many aspects of the financial services industry that took effect in 2013 and continue into 2017.

Embedded in Dodd-Frank is a series of disclosures that public companies are required to make in many of their public reports, including those issues quarterly, annually and proxy statements. Obviously, auditors and board members must be aware of these disclosures:

1. *Section 951: Shareholder vote of executive compensation*: Not less frequently than once every three years, there shall be a shareholder vote to approve the compensation of executives

2. *Section 952:*

    a. *Independence of compensation committee members:* Each member of the compensation committee of the board of directors of an issuer must be a member of the board of directors and be independent.

    b. *Independence of compensation committee advisers*: The compensation committee of an issuer (public company) may only select a compensation consultant, legal counsel, or other adviser to the compensation committee who is independent.

3. *Section 982*: Makes auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight.

In addition, Dodd-Frank provides a series of required disclosures that auditors and board members should understand.

Following is a chart that summarizes those disclosures.

New Disclosures Under Dodd-Frank Act	
Section and required disclosure	**When required**
Section 942: Requires issuers of asset-backed securities, at a minimum, to disclose asset-level or loan-level data, including: • data having unique identifiers relating to loan brokers or originators • the nature and extent of the compensation of the broker or originator of the assets backing the security, and • the amount of risk retention by the originator and the securitizer of such assets.	Registration statements
Section 951: Requires disclosure of: • any agreements that a company has with its executive officers concerning any compensation that a company will pay out to its executive officers that is based on the acquisition, merger, consolidation, sale, or disposition of substantially all of the assets, and • the total compensation that may be paid and the conditions upon which it will be paid	Proxy or consent material
Section 952: Requires disclosure of whether: • a company's compensation committee retained or obtained the advice of a compensation consultant, and • the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.	Proxy or consent material
Section 953: Require disclosure of: • the median of the annual total compensation of all employees of the issuer, except the chief executive officer (a) • the annual total compensation of the chief executive officer (or any equivalent position) of the issuer (b), and • the ratio of (a) to (b).	Proxy or consent material
Section 955: Requires disclosure as to whether any employee or member of the board of directors is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities: • granted to the employee or member of the board of directors as part of the company compensation, or • held, directly or indirectly, by the employee or member of the board of directors.	Proxy or consent material
Section 1502: Requires disclosure when a company uses "conflict minerals" (gold, wolframite, columbite-tantalite,	Annual reports and filings

etc.) that are necessary to the functionality or production of its product (such as jewelry manufacturing, etc.): • whether conflict minerals originated in the Democratic Republic of the Congo (DRC) or an adjoining country. **Note:** If "conflict minerals" did originate in the DRC, the company must submit an audited report to the SEC that includes a description of the measures taken to exercise due diligence on the source and chain of custody of such minerals. • a description of the products manufactured that are not DRC conflict free, the entity that conducted the independent private sector audit, the facilities used to process the conflict minerals, the country of origin of the conflict minerals, and the efforts to determine the mine or location of origin with the greatest possible specificity. **Note:** "DRC conflict free" means products that do not contain minerals that directly or indirectly finance or benefit armed groups in the Democratic Republic of the Congo or an adjoining country).	
Section 1503: If a company or its subsidiary is an operator of a coal or other mine, the company must disclose the following: 1. For each coal or other mine: • the total number of violations of mandatory health or safety standards that could significantly and substantially contribute to the cause and effect of a coal or other mine safety or health hazard for which the operator received a citation from the Mine Safety and Health Administration • the total number of orders • the total number of citations and orders for unwarrantable failure of the mine operator to comply with mandatory health or safety standards • the total number of flagrant violations • the total number of imminent danger orders issued • the total dollar value of proposed assessments from the Mine Safety and Health Administration • the total number of mining-related fatalities • the receipt of an imminent danger order issued by the Federal Mine Safety and Health Act, and • the receipt of written notice from the Mine Safety	Quarterly and 8K reports

and Health Administration that the coal or other mine has a pattern of violations of mandatory health or safety standards that are of such nature as could have significantly and substantially contributed to the cause and effect of coal or other mine health or safety hazards, or the potential to have such a pattern. 2. A list of such coal or other mines, of which the company or its subsidiary is an operator, that receive written notice from the Mine Safety and Health Administration of: • a pattern of violations of mandatory health or safety standards that are of such nature as could have significantly and substantially contributed to the cause and effect of coal or other mine health or safety hazards, or • the potential to have such a pattern. 3. Any pending legal action before the Federal Mine Safety and Health Review Commission involving such coal or other mine.	
Section 1504: Requires each resource extraction company (oil, natural gas, or minerals) to disclose any payment made by the company (directly or indirectly) to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals, including: • the type and total amount of such payments made for each project of the resource extraction issuer relating to the commercial development of oil, natural gas, or minerals, and • the type and total amount of such payments made to each government.	Annual reports and filings
Source: Dodd-Frank Wall Street Reform and Consumer Protection Act	

Observation: As the reader looks at the list of disclosures required in Dodd-Frank, few of them have anything to do with providing meaningful information to investors. Instead, information such as the purchase of conflict minerals in the Democratic Republic of Congo, or the safety record of coal mine operators, are politically charged and most likely forced into the Dodd-Frank law by constituents with an agenda. Because Congress funds the SEC, it can use the SEC to force public companies to adopt certain actions to avoid being "shamed" through public disclosure. For example, shareholders of a diamond company may not care whether the company purchases diamonds from the Congo as long as the company is profitable and stock price remains high. Now change that fact as the company is required to disclosure that it purchases certain materials from the Congo. Once that disclosure becomes public, stakeholders may place pressure on the company to change its policy to avoid the publicity that may result from the disclosure. Similarly, it should

be irrelevant how much a company pays its executives in relation to its employees as executive compensation is generally the responsibility of a company's board of directors who, in turn, represent the shareholders. Section 953 of Dodd-Frank adds a new disclosure in which a company is required to disclose the ratio of compensation made to its employees as a multiple of executive compensation. Why is this information relevant if the company has a board of directors? The answer is that it is not relevant and is required solely to appease certain groups that believe executives are overpaid.

Trump administration changes: In 2017, the Trump administration announced its plan to scale back many of the arduous requirements in Dodd-Frank. Considering that plan, query whether part of the possible changes will be a reduction in some of the disclosures the recent expansion of company disclosures lead by Dodd-Frank, one must ask where disclosures are headed and whether Congress, through the SEC, will continue with its effort to expand company disclosures to promote a political agenda instead of doing its job, which is to protect investors within the marketplace.

SEC focuses on missing disclosures

Beyond the new requirements under Dodd-Frank, the SEC has expanded its review of company disclosures in annual and interim reports.[22]
SEC comment letters have focused on the following key areas:

1. Revenue Recognition, including the accounting policy used

2. Related-party transactions and disclosures

3. Fair-value measurements, including management's judgment used to determine fair value

4. Intangible assets and goodwill, including testing for impairment

5. Disclosure controls including wording used in the certificate

6. Executive compensation

7. Management Discussion and Analysis, including more information about liquidity, accounting estimates and capital resources.

8. Segment reporting including how companies are dividing business units

9. Non-GAAP measures, including information that is being disclosed in press releases, websites, and analyst calls, and

10. Debt and equity issues including valuation and disclosure.

Will such disclosures spread into the financial statements of non-public companies?

[22] Audit Analytics, as published by CFO.com.

It is not clear. The SEC has the power to put pressure on the FASB to enhance disclosures. Although the emphasis in expanding disclosures surrounds public companies, we continue to see the FASB's unwillingness to carve out disclosure exclusions for non-public companies.

One can see a future in which there is an expansion of politically charged disclosures that are wrapped into existing GAAP.

SEC conflict minerals disclosures

Section 1502 of the Dodd-Frank Act and Section 13(p) of the Securities Exchange Act of 1934 (the "Exchange Act") require companies to publicly disclose their use of conflict minerals that originated in the Democratic Republic of the Congo or an adjoining country.

Section 1502 directs the SEC to issue rules requiring certain companies to disclose their use of conflict minerals if those minerals are "necessary to the functionality or production of a product" manufactured by those companies. On August 22, 2012, **the SEC adopted rules and guidance as required by Section 1502.**

The scope of the new rules is expansive, both in terms of the number of public companies potentially impacted and the extent of information required to be reported. The expense required to comply with the new rules could be quite substantial for those companies required to make disclosures.

The disclosures required under the new rules must be filed on a "Conflict Minerals Report" using Form SD. The first reports were due *May 31, 2014*.

For purposes of the new rules, "*conflict minerals*" are defined as:

- cassiterate
- columbite-tantalite (also known as coltan)
- gold, and
- wolframite and their derivatives: tantalum, tin and tungsten.

These conflict minerals are commonly known to originate, and in some cases finance armed groups, in the Democratic Republic of Congo and the adjoining countries that include Angola, Burundi, the Central African Republic the Republic of Congo, Rwanda, Sudan, Tanzania, Uganda and Zambia (collectively, the "Covered Countries").

Under the rules, companies must use a three-step process:

Step One: A company must determine if it is subject to the new rules based on its use of conflict minerals.

a. A company is subject to the rules if:

   1) it is a public company under SEC, and

2) conflict minerals are necessary to the *functionality* or *production of a product manufactured by the company* or *contracted by the company to be manufactured*.

Note: Whether a company "contracts to manufacture" a product depends on the degree of influence exercised by the issuer on manufacturing of the product. The SEC has indicated that issuers will not be viewed as "contracting to manufacture" a product if their actions involve no more than:

- specifying or negotiating contractual terms with a manufacturer that do not relate directly to manufacturing of the product
- affixing its brand, marks, logo, or label to a generic product manufactured by a third party, and
- servicing, maintaining, or repairing a product manufactured by a third party. But it is understood, for example, that a semiconductor supplier that relies on third party foundries for production of its products would ordinarily be covered by the rules.

Step Two: A company that is subject to the rules must conduct a country of origin inquiry to determine if the conflict minerals it uses originated in one of the Covered Countries or came from recycled or scrap sources.

Step Three: A company that determines, or has reason to believe, that its conflict minerals originated in a Covered Country and are not from recycled or scrap sources must conduct diligence as to the source and chain of custody and may be required to file a *Conflict Minerals Report.*

a. All conflict minerals disclosures must be provided using Form SD.

Note: The disclosure is not automatically incorporated into registration statements filed under the Securities Act of 1933 and is not covered by executive officer certifications required in connection with the Form 10-K.

What is the estimated cost of compliance with the conflict minerals disclosure?

The SEC estimates the initial compliance costs for the Conflict Minerals Rule was about $3 to $4 billion, and ongoing compliance costs at about $200 to $600 million, annually.

Retailers and the conflict minerals rule

In the first version of the SEC rule, retailers such as Target and Wal-Mart that sell goods produced by outside contractors would have been subject to the conflict minerals rule if they sold retail products under their own brand. However, in the final vote, the SEC ruled that such retailers are exempt, if they don't have any control over the manufacture of products sold under their brand name.

IX. Whistleblowing- The New Profession Acts Like the Oldest Profession

As the author discussed earlier in this course, one of the most effective ways in which a company can prevent fraud is to have a tip hotline or whistleblowing mechanism within the organization.

The *2016 Report to the Nation*, by the Association of Certified Fraud Examiners, supports the effectiveness of a company having an employee hotline and/or whistleblowing mechanism:

1. In 39% of the cases reported, the initial method of fraud detection was tips from various sources.

2. In those cases where companies had implemented a tip hotline mechanism, both the median fraud loss and detection time declined by 50%.

3. Granting rewards for having a fraud hotline ranked as a very effective control in detecting and limiting financial statement fraud schemes.

There is heightened pressure on public companies to establish effective anonymous hotlines and whistleblowing systems, including compensation for coming forward as a whistleblower.

1. Section 806 of Sarbanes-Oxley Act provides whistleblower protection for employees of public companies in that it:

    a. Prevents a company from discharging, demoting, suspending, threatening, harassing, or discriminating an employee for providing information or assisting in an investigation that the employee *reasonably believes* constitutes fraud

    b. Requires a company to rehire an employee with back pay (and interest) if an employee is violated for whistleblowing, and

    c. Requires company boards to establish procedures for hearing whistleblowing complaints.

2. Section 922 of Dodd-Frank expands the protections and offers financial incentives for whistleblowers[23] and addresses the following:

    a. Establishes a whistleblower rewards fund to pay awards to whistleblowers equal to between 10 to 30 percent of the total collected when monetary sanctions exceeding $1 million are imposed on a public company for securities law violations that exceed $1 million, based on information that is:

        - Derived from the whistleblowers original knowledge

[23] Dodd-Frank defines a whistleblower as any individual (or individuals) who provide information to the SEC about a company's securities law violation. The definition expands well beyond an employee to any third party, investor, etc.

- Not known by the SEC from any other source, and

- Not exclusively derived from any judicial or administrative hearing, or other report or news media.

b. Provides legal remedies for an individual who alleges discharge or other discrimination due to whistleblowing with such relief consisting of:

- Reinstatement with the same seniority status that the individual would have had, but for the discrimination

- Two times the amount of back pay otherwise owed to the individual, with interest, and

- Compensation for litigation costs, expert witness fees, and reasonable attorneys' fees.

Although whistleblowing can be useful, the legal remedies and rewards included in Sarbanes Oxley coupled with those found in the Dodd-Frank Act, provide employees and other parties with the means by which to leverage certain proprietary corporation information for financial gain. In fact, recent cases show that some employees are using the whistleblowing protections to retaliate against management or to extract concessions in a contract negotiation or severance pay package.

Two recent cases suggest that auditors or boards that ignore whistleblowers, do so at their own peril.

CASE 1:

In the first case, the *State of New York v. Ernst & Young*, the State of New York alleged that Ernst & Young failed to disclose whistleblower allegations in connection with Lehman's use of Repo 105, among other matters.

In the Ernst & Young case, the auditors received a letter from a whistleblower, sent to Lehman's audit committee. The auditors interviewed the whistleblower and dismissed the allegations. Subsequently, in the State of New York complaint, the plaintiff alleged that the auditor failed to disclose the results of the whistleblower's interview to the Lehman audit committee.

CASE 2:

In the second case, under obvious pressure from regulators, Renault inadvertently terminated several employees based on information obtained from a whistleblower.

A whistleblower claimed that a Renault executive was engaged in a bribe. After an intensive investigation, Renault terminated three employees and announced publicly it had evidence against them, even though there was no such evidence of any bribes or improprieties. Subsequently, Renault admitted it had committed an error and has since exonerated the three employees.

It is obvious that the Ernst & Young and Renault cases are examples at opposite ends of the spectrum, with Ernst & Young being accused of not taking enough action in a whistleblower case, while Renault was criticized for being overly aggressive in handing its case.

With the financial incentives of Dodd-Frank, there is a new whistleblowing industry that has cropped up including web sites, blogs, and law firms that advertise to represent whistleblowers.

Do the Sarbanes Oxley and Dodd-Frank whistleblower provisions apply to non-public companies?

The SEC adopted rules to implement to Dodd-Frank's Section 922 whistleblower rules. Section 922 applies to whistleblowers that voluntarily provide "original information" to the SEC that leads to the recovery of more than $1 million from the violation of federal securities laws. Thus, the perpetrator is generally an SEC registrant in some form.

On its face, Section 922 applies to public (SEC) companies and therefore, employees of those SEC companies, even though a whistleblower can be any party, not limited to employees.

However, there are a number of ways in which a private (nonpublic) company can be subject to Dodd-Frank.

Lawson v. FMR LLC

The Supreme Court issued a decision on whistleblower protections involving Sarbanes Oxley, not Dodd-Frank.

The issue in *Lawson* is whether the whistleblower protections of Sarbanes-Oxley protects employees of privately-held companies, if those companies are working as contractors for public companies.

In *Lawson v. FMR LLC*, the Supreme Court held that Sarbanes Oxley's whistleblower statute applies not only for the employees of public companies, *but also for employees of non-public companies that perform work for public companies.*

Facts:

- Jackie Lawson and Jonathan Zang, were employees of Fidelity Investment Advisory Companies, a nonpublic investment adviser company. Fidelity had contractual relationships with public "investment companies," or mutual funds, that they advised.

- Lawson and Zang (employees of Fidelity) reported shareholder fraud at their clients, public mutual funds.

- Fidelity allegedly retaliated against the employees for their reporting of alleged fraud against the public company client.

- The employees sued their employers under Section 806 of Sarbanes-Oxley alleging that they had been retaliated against by the nonpublic employer after they reported the alleged shareholder fraud at the public mutual funds.

- Fidelity (defendants) moved to dismiss plaintiffs' (employees') complaints on the ground that Sarbanes Section 806 applies only to employees of public companies, and not to employees of nonpublic contractors.

- The district court disagreed and ruled for the employees (plaintiffs).

What does the Lawson decision mean for nonpublic entities?

Although the Lawson decision applies to Sarbanes Oxley, The whistleblower provisions of Dodd-Frank are far more liberal and broader in scope than Section 806 of Sarbanes.

Section 806 of Sarbanes states that:

> *"No [public] company . . ., or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of [whistleblowing or other protected activity]."*

The *Lawson* decision expands the list of employees who may seek to bring suit under the Sarbanes Oxley (or Dodd-Frank) whistleblower provision.

1. The Sarbanes (and Dodd-Frank) whistleblower protections extend to employees of contractors and subcontractors, even if those contractors are nonpublic entities.

2. The courts have not decided whether the whistleblower provision extends to non-public company shareholders of the subcontractors, if it does apply to its employees.

   Note: The extent to which a nonpublic entity could be subject to the Sarbanes (and Dodd Frank) whistleblower claims is yet to be decided by the courts. The rules state that an entity is not permitted to retaliate against employees for reporting what they "reasonably believe" to be a violation of the federal laws regarding mail, wire, and bank fraud, securities fraud, and "any rule or regulation of the Securities and Exchange Commission."

   Yet, there is likely to be continued litigation to address some of the issues involving nonpublic entities:

   Examples of questions still to be answered by the courts:

   Do the whistleblower anti-retaliation protection provisions apply to an employee of a non-public company who accuses her employer of wire fraud?

   What if the accusation is unrelated to the work performed for the public company?

What if the contract with the public company is unrelated to public accounting or securities compliance?

Eagan case

In *Egan v. Trading Screen, Inc*., the courts resolved whether employees must report whistleblower information to the SEC directly or can it be brought first to the company board or management.

Facts:

- TradingScreen is a privately-held financial software provider that facilitates Internet stock trading by hedge funds, asset managers and private bankers, among others.
- Patrick Egan was TradingScreen's Head of Sales.
- Egan learned that the company's CEO was diverting corporate assets to another company owned by the CEO.
- Egan reported his allegations to the company president, who in turn passed the information on to TradingScreen's independent directors.
- Based on an internal investigation, led by a law firm, findings supported Egan's allegations. But before disciplinary action could be taken against the CEO, he gained control of the full board and fired Egan.
- Egan filed suit in the United States District Court claiming, among other things, that his termination violated Dodd-Frank's ant retaliation provisions.
- Defendants moved to dismiss the complaint arguing that because Egan reported his allegations only internally within the company, and not to the SEC, he did not qualify as a "whistleblower" within the statutory framework of Dodd-Frank.
- The court determined that although a literal reading of the definition of the term 'whistleblower' would suggest that communication must be made directly to the SEC, such a narrow definition would effectively invalidate the protection of whistleblower disclosures.
- The court rules that an individual does not need to personally report to the SEC in order to qualify for anti-retaliation protection, provided that a report is made to the SEC by someone with whom the individual is "acting jointly."

Does Dodd-Frank apply to whistleblowers who are not employees?

A key difference between Dodd-Frank's whistleblower statute and the one found in Sarbanes Oxley is that Dodd-Frank's statute is very broad. Therefore, a whistleblower can be anyone who "reasonably believes" that there has been a violation of securities law. To date, the courts have ruled in favor of a broad scope of Dodd-Frank's whistleblower statute, consistent with the original intent of Congress.

Is there an incentive for a whistleblower to overreact and report to the SEC prematurely?

There is an obvious incentive for a whistleblower to be the first one to notify the SEC. Dodd-Frank provides that in order for a whistleblower to collect his or her reward, the information provided to the SEC must be fresh, meaning it must be:

- Derived from the whistleblowers original knowledge,
- Not known by the SEC from any other source, and
- Not exclusively derived from any judicial or administrative hearing, or other report or news media.

Once information is already divulged, the whistleblower's information is stale and there is no reward. Also, there is no real penalty for a whistleblower to exaggerate or to be wrong about his or her allegation. Section 806 of Sarbanes-Oxley provides that an employee has to "reasonably believe" there is a fraud in order to be protected from company retaliation.

How good is the financial incentive for whistleblowers?

Dodd-Frank has certainly enhanced the financial incentive for whistleblowers against a company and to do it early. Dodd-Frank allows an employee-whistleblower who a company retaliates against to receive two times the amount of back pay (including interest), and reimbursement of compensation for litigation costs, expert witness fees, and reasonable attorneys' fees.

The reward, itself, is 10 to 30 percent of the money that the SEC receives for a company's securities law violations that include fraudulent financial reporting, Foreign Corrupt Practices Act (FCPA) violations, and insider trading, among others. Some violations, such as violation of the FCPA can result in fines that are millions of dollars.

Is there an incentive for a company to offer a mechanism for employees to report a violation to the company first, before going to the SEC?

The SEC is considering regulations that would allow an employee to whistleblow to a company before going to the SEC and still collect the SEC reward. In providing such a structure, companies would be more likely to establish a corporate culture that promotes employees to come forward with SEC violations, and *allow companies to correct the actions internally*. However, such a structure would have to include a company-level financial incentive for whistleblowers.

SEC's Report on the Dodd-Frank Whistleblower Program

In November 2016, the SEC published its fourth annual report on the Dodd-Frank Whistleblower Program entitled, *2016 Annual Report to Congress on the Dodd-Frank Whistleblower Program.*

The Report stated that in the fiscal year ended September 30, 2016, *the SEC received 4,200 tips spanning all 50 states*. Approximately 10 percent of the tips received related to tips involving foreign companies.

a. 50 percent of the complaints received related to:

   - Corporate disclosures and financial statements (22.8%)
   - Offering Fraud (15.7%)
   - Market manipulation (11.5%)

b. At September 30, 2016, there was approximately $368 million remaining in the whistleblower fund available to pay out for future whistleblower claims.

c. During fiscal year 2016, $35 million of payouts were made to whistleblowers.

Observation: Can one imagine the extent to which whistleblowers are providing tips under the SEC's whistleblower program? In the first seven weeks of operation, there were 334 tips submitted to the SEC, followed by 3,001 in the second year, 3,238 in the third year, 3,620 in the fourth year, 3,923 in the fifth year, and 4,200 in the most recent year. With a fund balance of $368 million at November 2016, and presumably unlimited funds from Congress, the SEC's whistleblower program may become a full-time business for many disgruntled employees seeking a sizeable payday at the expense of their employer. Another key point is that there is no recourse against an employee or other party for making a false claim under the whistleblower program. Consequently, employees and others are incentivized to file tips with the SEC, even if those tips may not be valid.

X. Auditor Rotation

The European Union has formalized a law that provides for mandatory audit firm rotation.

The new law includes a requirement that public entities rotate audit firms every 10 years. There are exceptions under which the 10-year period is extended to 20 years if the engagement is put out for bid, or 24 years for joint audits. The mandatory rotation rules apply to public-interest entities that consist of listed companies, banks, and insurance companies.

The rules provide for the following:

- A 10-year mandatory rotation requirement for audit firms, with extensions to 20 years for engagements put out for bid, and 24 years for joint audits.

- EU audit firms are prohibited from providing certain nonaudit services to public-interest entities that they also audit. Prohibited nonaudit services include certain tax consulting services.

- Fees from nonaudit services to an audit client cannot exceed 70 percent of the audit fees.

- Loan agreements cannot have clauses requiring that a Big Four firm perform the audit.

What about the United States?

The PCAOB tried to implement auditor rotation but Congress voted to stop the process.

Upon proposing an auditor rotation several years ago, the PCAOB has encountered significant resistance from companies who are concerned about the negative impact that rotation would have on overall audit quality and cost.

Does auditor rotation work?

There have been several studies that address whether auditor rotation results in higher quality auditors.

The GAO did a study of auditor rotation and issued a report, *Mandatory Audit Firm Rotation Study,* based on a survey of larger auditing firms and Fortune 1000 companies.

In the GAO Study, respondents made the following comments and suggestions regarding mandatory auditor rotation.

- 54% stated that initially, after a change in auditors, a new auditor would have less knowledge of a client's operations and financial reporting practices.

- 93% stated that initially, the new auditor is likely to have greater risk of there being a material misstatement.

- Estimated initial-year audit costs would increase by more than 20% with a change in auditors.

The U.S. Chamber of Commerce also performed its own survey of its members with 92 percent of respondents opposing the PCAOB proposal.

Comments made by the U.S. Chamber of Commerce based on its respondent survey included:[24]

- There is no evidence that audit firm tenure is an issue in audit quality.

- Mandatory audit firm rotation would be costly and disruptive to the markets.[25]

- The PCAOB lacks authority for mandating audit firm rotation as such authority lies with the SEC and not the PCAOB.

Still, a third study done in Europe addressed the issue of auditor rotation.

In that study, the following results were published:[26]

- There is no significant difference in the perceived audit quality immediately after a mandatory and a voluntary audit firm change.

- There is no evidence that there are net benefits of mandatory audit rotation on audit quality.

For now, the auditor rotation debate is on hold in the United States even if it is alive and well in Europe.

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[25] The Financial Executives Research Foundation noted that the average SEC company would pay more than $220,000 of
additional audit fees if auditor rotation was required.

[26] *Does Mandatory Auditor Rotation Really Improve Audit Quality?* Mara Cameran, Ph.D, et al.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. Which of the following is correct as it relates to auditors who issue adverse opinions on their clients' internal control over financial reporting:
   a. There is a high correlation between an auditor issuing an adverse opinion and not being paid
   b. There is a high correlation between an auditor issuing an adverse opinion and being sued
   c. Companies that receive an adverse opinion are more likely to dismiss their auditor in the following year
   d. There is the same correlation between an auditor issuing an unmodified opinion and an adverse opinion, in terms of whether the auditor is dismissed

2. What does Section 404 of the Sarbanes-Oxley Act require:
   a. In the company's annual report to shareholders, management must state whether the company's internal controls are effective
   b. Management of private companies must assess the effectiveness of the company's internal control over financial reporting
   c. Audit reports must disclose both material weaknesses and significant deficiencies
   d. The auditor must include in the company's financial statements two opinions on the effectiveness of internal control over financial reporting

3. Based on historical data, the typical successful going private transaction involves:
   a. A large company with revenues in the trillions
   b. A company in the financial sector
   c. Management using private capital for an acquisition
   d. Fairly expensive price-per-earnings ratio

4. Which of the following is a correct fact related to D&O insurance:
   a. Some policies include a defense allocation provision
   b. In the post-Sarbanes era, the cost of D&O insurance has consistently decreased
   c. All major insurance carriers offer compliance-specific insurance products such as those required by Sarbanes section 404
   d. All policies cover negligent acts under Sarbanes

5. According to "*What Every Director Should Know About the New Environment*," what are the trends with respect to directors operating in today's business climate:
   a. Board members' behavior is independent of a company's actions
   b. It is insufficient for board members to rely on company-generated information
   c. The former rules defining directors' "good-faith obligation" are sufficient
   d. There should be a greater connection between the CEO and the chairman of the board

6. How does the Sarbanes-Oxley Act continue to affect accountants and auditors of nonpublic entities:
   a. All states are adopting the Act in their accountancy acts
   b. For fixed-fee arrangements, auditors must perform more audit work
   c. Fewer GAAP and GAAS statements are being issued for nonpublic entities
   d. More companies are going public because of the Act

7. According to a recent survey, which Sarbanes provision are private companies implementing at the greatest percentage:
   a. Audited financial statements
   b. CFO/CEO financial statement certification
   c. Disclosure of off-balance sheet and contingent liabilities
   d. Section 404 compliance requirements

8. Dodd-Frank makes several changes that affect both auditors and board members. Which of the following is one of those changes:
   a. No less frequently than once every three years, there shall be a shareholder vote to approve executive compensation
   b. No less frequently than once every five years, there shall be a board of directors vote to approve dividends to be paid
   c. Once every year, there shall be a shareholder vote to select the auditor
   d. Once every two years, there shall be a vote of senior management to approve dividends

9. _____ is a conflict mineral as defined by the Dodd-Frank Act (the Act):
   a. Gold
   b. Silver
   c. Titanium
   d. Copper

10. Which of the following is a change made by the Dodd-Frank Act that affects whistleblowers. The Act _____.
   a. Provides companies with a legal remedy if an employee makes a false claim as a whistleblower
   b. Allows for the reinstatement of an employment who whistle blows
   c. Provides for five times the amount of any back pay
   d. Allows an attorney to collect legal fees from a whistleblower

SUGGESTED SOLUTIONS

1. Which of the following is correct as it relates to auditors who issue adverse opinions on their clients' internal control over financial reporting:
   a. Incorrect. There is no published correlation between an auditor issuing an adverse opinion and not being paid, making the answer incorrect.
   b. Incorrect. There is no reported correlation between an auditor issuing an adverse opinion and being sued
   c. Correct. According to one study, companies that receive an adverse opinion are more likely to dismiss their auditor in the following year as part of an effort to improve overall financial reporting quality.
   d. Incorrect. An auditor who issues an adverse opinion is more likely to be dismissed that one who issues an unmodified opinion.

2. What does Section 404 of the Sarbanes-Oxley Act require:
   a. Correct. Section 404 of the Sarbanes-Oxley Act requires that management include in the management's conclusion of the company's annual report to shareholders whether, as a result of its assessment, the company's internal controls are effective.
   b. Incorrect. Section 404 of the Sarbanes-Oxley Act requires that management of a *public* company (not a private company) assess the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.
   c. Incorrect. Section 404 of the Sarbanes-Oxley Act requires that the audit report disclose *only* material weaknesses and *not* significant deficiencies.
   d. Incorrect. Section 404 of the Sarbanes-Oxley Act, as amended by AS5, requires that the auditor issue one opinion on the effectiveness of internal control over financial reporting that are included in the company's published financial statements along with the audit report on those statements.

3. Based on the historical data, the typical successful going private transaction involves:
   a. Incorrect. The typical successful going private transaction involves a *relatively small* company with revenues *around $80 million and a market capitalization of $40 million*.
   b. Incorrect. The typical successful going private transaction that has occurred involves a company in the *consumer, information technology, or industrials* sectors.
   c. Correct. The typical successful going private transaction that has occurred involves an acquisition by management using private capital.
   d. Incorrect. The typical successful going private transaction that has occurred involves fairly *inexpensive* price-per-earnings ratio (5.5 times EBITDA).

4. Which of the following is a correct fact related to D&O insurance:
   a. Correct. Some policies include a defense allocation provision that allows the insurance company to pay only a portion of legal defense costs when some of the claims are covered and others are not under the policy.
   b. Incorrect. In the post-Sarbanes era, insurance costs increased from 2002 to 2003, then dropped from 2004 to 2011. Thus, the answer is incorrect.
   c. Incorrect. Some, but not all, major insurance carriers offer compliance-specific insurance products such as those required by Sarbanes section 404.

d. Incorrect. Some policies exclude negligent acts under Sarbanes, while others include it in certain instances.

5. According to "What Every Director Should Know About the New Environment," what are the trends with respect to directors operating in today's business climate:
   a. Incorrect. Board members' behavior has been looked at more closely than ever thereby linking it to a company's actions.
   b. Correct. The courts have maintained that it is insufficient to rely on company-generated information. Board members must search for information outside the company to assist them in making decisions.
   c. Incorrect. A new set of rules defining directors' "good-faith obligation" is being shaped by the courts that increases the responsibility to directors.
   d. Incorrect. There should be a greater separation between the CEO and the chairman of the board to ensure that the board is independent of management.

6. How does the Sarbanes-Oxley Act continue to affect accountants and auditors of nonpublic entities:
   a. Incorrect. Many, but not all, states are adopting the Act in their accountancy acts and are requiring that the provisions apply to all auditors of nonpublic entities.
   b. Correct. Due to the increase in audit and accounting work that has trickled down from Sarbanes, accountants and auditors must perform more audit work. In fix-fee engagements, they may have difficulty passing the additional cost onto their clients.
   c. Incorrect. More GAAP and GAAS statements are being issued that apply to both public and nonpublic entities.
   d. Incorrect. The Act has made going public less appealing for many companies.

7. According to a recent survey, which Sarbanes provision are private companies implementing at the greatest percentage:
   a. Correct. According to a recent survey, 93% of the respondents of private companies are implementing audited financial statements.
   b. Incorrect. Only 59% of the respondents of private companies are implementing CFO/CEO financial statement certification.
   c. Incorrect. Only 81% of the respondents of private companies are implementing disclosure of off-balance sheet and contingent liabilities.
   d. Incorrect. Due to the stringent Section 404 compliance requirements, few private companies have adopted Section 404.

8. Dodd-Frank makes several changes that affect both auditors and board members. Which of the following is one of those changes:
   a. Correct. Dodd-Frank requires that not less frequently than once every three years, there shall be a shareholder vote to approve executive compensation.
   b. Incorrect. There is no provision dealing with five years, and no requirement for the board to approve dividends to be paid at each five-year interval.
   c. Incorrect. First, in general the board selects the auditor, and second there is no annual requirement in Dodd-Frank.
   d. Incorrect. The board of directors approves dividends and not senior management.

9. _____ is a conflict mineral as defined by the Dodd-Frank Act (the Act):
   a. Correct. Gold is one of the conflict minerals defined under the Dodd-Frank Act making the answer correct.
   b. Incorrect. Silver is not one of the conflict minerals identified by the Act.
   c. Incorrect. Titanium is not one of the conflict minerals identified by the Act.
   d. Incorrect. Copper is not one of the conflict minerals identified by the Act.

10. Which of the following is a change made by the Dodd-Frank Act that affects whistleblowers. The Act _____.
   a. Incorrect. Dodd-Frank provides whistleblowers, not companies, with a legal remedy if an employee makes a false claim as a whistleblower.
   b. Correct. Dodd-Frank allows for the reinstatement of an employee who whisteblows in certain instances.
   c. Incorrect. It provides for three times, not five times, the amount of any back pay.
   d. Incorrect. It allows for a whistleblower to collect legal fees from a company who violates Dodd-Frank.

XI. Peer Review

Recurring peer review comments

The following information was obtained from the Auditing Standards Board along with data compiled by the AICPA Peer Review Program. Many of the following items were covered in Risk Alerts, and continue to recur in practice year after year.

Significant engagement deficiencies	
Failure to: • Appropriately qualify an auditor's report for a scope limitation or departure from the basis of accounting used for the financial statements. • Issue a report on compliance and internal controls for audits subject to Government Auditing Standards. • Disclose the lack of independence in a compilation report. • Disclose the omission of substantially all disclosures in a compilation that omits disclosures. • Disclose the omission of the statement of cash flows in financial statements prepared in accordance with GAAP. • Disclose an other comprehensive basis of accounting (OCBOA)[27] for financial statements compiled without disclosures, where the basis of accounting is not readily determinable from reading the report. • Disclose, in the accountant's or auditor's report, a material departure from professional standards such as the omission of significant income tax provision on interim financial statements, significant disclosures related to defined employee benefit plans, etc.	• Departures from standard wording where the report does not contain the critical elements of applicable standards. • Issuance of an audit or review report when the accountant is not independent. • Inclusion of material balances that are not appropriate for the basis of accounting used. • Significant departures from the financial statement formats prescribed by industry accounting and auditing guides. • Omission of the disclosures related to significant accounting policies applied (GAAP or OCBOA). • Omission of significant matters related to the understanding of the financial statements, such as the cumulative material effect of a number of deficiencies. • Improper accounting for a material transaction such as recording a capital lease as an operating lease. • Misclassification of a material transaction or balance. • Failure to include a summary of significant assumptions in a forecast or projection. • Failure to segregate the statement of cash flows into the categories of investing, operating and financing.

[27] Effective in 2012, the term special purpose framework is used to describe a non-GAAP framework.

• Include a material amount or balance necessary for the basis of accounting used (examples include omission of material accruals, failure to amortize a significant intangible asset, provide for material losses or doubtful accounts, or to provide for material deferred income taxes.)	• Omission of significant required disclosures related to material financial statement balances or transactions. • Failure to disclose the cumulative effect of a change in accounting principle. • Omission of the statement of income and retained earnings when referred to in the report.
Minor engagement deficiencies	
Supplementary information: • Failure to report on supplementary information. • Supplementary information was not clearly segregated or marked. • Titles of supplementary information did not coincide with the descriptions and titles presented in the financial statements. *Reports:* • Minor departures from standard report language. • Report did not cover all periods presented. • Minor report dating departures. *Other*: • Failure to accrue income taxes where the accrual is not material. • Inclusion of the reference about the omission of the statement of cash flows for financial statements prepared under OCBOA. • Failure to reference the accountant's report on each page of the financial statements. • Failure to identify within the audit report the country of origin.	*Disclosures*: • Omitted or inadequate disclosures related to minor account balances or transactions such as inventory, valuation allowances, long-term debt, related-party transactions, and concentrations of credit risk. *Financial statement display*: • Minor departures from the financial statement formats recommended by industry accounting guides. • Use of financial statement titles that are not appropriate for the basis of accounting used. • Failure to include the title "Selected Information-Substantially All Disclosures Required by GAAP Are Omitted." As appropriate for the presentation of certain selected disclosures. • Presentation of treasury stock in the financial statements of a company that is incorporated in a state that does not recognize treasury stock.
Audit procedures and documentation:	
Failure to:	Failure to:

• Use a written audit program. • Tailor audit programs for specialized industries or for a specific type of engagement, such as significant areas of inventory and receivable balances. • Request a legal representation letter, if an attorney was consulted. • Obtain a client management representation letter. • Include several components of a client management representation letter within the letter. • Document the auditor's consideration of the internal control structure. • Document key audit areas. • Document tests of controls and compliance for engagements subject to OMB Circular A-133. • Assess or document fraud risk.	• Perform essential audit procedures required by an industry audit guide. • Perform adequate tests in key audit areas. • Confirm significant receivables or document appropriateness and utilization of other audit techniques. • Assess the level of materiality and control risk. • Document the nature and extent of analytical procedures. • Review loan covenants. • Perform audit cut-off procedures. • Document communications between predecessor and successor auditors. • Perform a review of subsequent events. • Test for unrecorded liabilities. • Observe inventory when the amount is material to the balance sheet.
Compilation and Review (SSARS) Procedures and Documentation:	
Failure to: • Perform analytical and inquiry procedures for a review engagement. • Document the matters covered in the accountant's inquiry and analytical procedures on a review engagement.	• Obtain a client management representation letter for a review engagement. • Include the required language in an engagement letter on a management-use only compilation engagement for communicating the understanding of the engagement for financial statements that are prepared for management use only, except for the failure to refer to the level of responsibility on supplementary information, which is not a significant deficiency.
Attestation Procedures and Documentation:	
Failure to: • Obtain a client management representation letter for an examination of internal control or regarding managements' assumptions for a pro forma financial statement.	

• Appropriately label pro forma financial information to distinguish it from historical financial information.	
Specific Common Financial Statement Deficiencies:	
Assets: • Improper classifications between current and long-term assets. • Investments in majority owned or controlled subsidiary not consolidated. • Cash overdrafts shown as a negative balance in the current asset section. • Accounts receivable shown on cash basis financial statements. • Investments in debt and equity securities not classified or measured correctly. **Statement of Income:** • Income tax provisions not recorded on interim financial statements. • Reporting period not clearly identified. • Significant components of income tax expense not disclosed. **Statement of Cash Flows:** • Cash flow statement not categorized by operating, investing and financing activities. • Misclassification of activities, especially between investing and financing activities. • No disclosure of non-cash investing and financing activities. • No disclosure of interest and taxes paid for indirect method. • No reconciliation between net income and net cash flow from operations. • Certain amounts in the statement of cash flows did not agree with amounts	**Liabilities:** • Improper classifications between current and long-term debt. • Demand liabilities classified as long-term. • Non-recognition of liability for compensated balances (e.g., vacation pay). • Non-recognition of capital leases. • Improper recognition of deferred revenue. • Improper classification of deferred income taxes.

calculated from the comparative balance sheets. • Cash flow statement not presented for each period that statement of income is presented.	

Incomplete and Missing Disclosures:	
Missing disclosures: • Significant accounting policies, such as revenue recognition. • Basis of accounting other than GAAP. • Concentrations of credit risk. • Disclosures about fair value of financial instruments. • Disclosures about risks and uncertainties. • Components of receivables. • Components of inventory. • Disclosure of five-year debt maturities. • Related party transactions. • Leases. • Inadequate employee benefit plan disclosures. • Inadequate disclosure about deferred taxes. • Missing caption "Selected Information-Substantially All Disclosures Omitted," where applicable. • Modifications to cash basis of accounting. • Use of estimates. • Accounting policy on bad debts. • Nature of operations.	• Information about concentrations of products, services, customers, and suppliers. • Inadequate subsequent event disclosure of significant unrealized stock market losses. • Interest expense. • Rent expense. • Investments. • Intangible assets. • Details related to long-term debt. • Preferred stock redemption requirements. • Details related to the components of capital stock. • Details related to components of retained earnings. • Restricted loan covenants. • Depreciation and amortization. • Cash equivalents. • Accrued compensation expense. • Advertising expense. • Income tax expense. • Terms and conditions of a commitment. • Details relating to pension plans.

Common Functional Area Deficiencies- Engagement	
Engagement performance: Failure to: • Perform an adequate review of working papers and/or the accountant's/auditor's report and accompanying financial statements by the practitioner-in-charge of the engagement prior to the issuance of the auditor's/accountant's report. • Perform pre-issuance review of engagement working papers and/or reports and accompanying financial statements by an independent party not associated with the engagement as required by firm policy. • Utilize a disclosure and reporting checklist as required by firm policy.	• Consult professional literature or with a source outside the firm on reporting for a specialized industry, which resulted in the issuance of an incorrect audit report, and/or financial statement disclosure or presentation. • Use accounting/auditing practice aids developed by third party providers as required by firm policy, which resulted in engagement deficiencies. • Use engagement letters for accounting/auditing engagements as required by firm policy.
Personnel management: • Failure of professional staff to take adequate CPE in accounting and auditing related subjects or specialized industries, which resulted in disclosure, reporting, and documentation deficiencies on engagements selected for review. *Monitoring:* Failure to: • Adequately implement the firm's monitoring policies and procedures.	• Document the firm's compliance with policies and procedures for its system of quality control as required by AICPA Quality Control Standards. • Perform an annual inspection, including the functional elements of quality control, as required by firm policy. • Extend monitoring policies and procedures to non-audit services such as compilation and/or review engagements.
Common Deficiencies Unique to Specialized Industries	
Engagements subject to government auditing standards	

• Missing reports for internal control or compliance. • Missing proper A-133 reports. • Required compliance testing not performed. • Compliance and control tests not adequately designed. • Inadequate or outdated reference materials used.	• Report on financial statements does not refer to reports on controls and compliance. • Yellow Book CPE requirements not met. • Improper accounting for a certain fund. • Failure to restrict the use of the accountant's report to the proper governmental agency.

Not-for-profit organizations	
Failure to: • Identify a voluntary health and welfare organization. • Present a statement of cash flows. • Inadequate format, titles and presentation of financial statements.	• Incorrect classification of contributions as unrestricted, temporarily restricted, or permanently restricted. • Inadequate audit procedures to support the statement of functional expenses. • Improper accounting for restricted funds.
Employee benefit plans	
• Inadequate testing of participant data and investments. • Inadequate or missing disclosures related to participant directed investment programs, investments and participant data. • Failure to understand testing requirements on a limited-scope engagement. • Inadequate consideration of prohibited transactions.	• Incomplete description of the plan and its provisions. • Failure to properly report on a DOL limited-scope audit. • Improper use of the limited scope exemption because the financial institution did not qualify for the exemption. • Failure to properly report on the supplementary schedules for ERISA and the DOL.
Tax-basis financial statements	
• Failure to state the basis of accounting and that the basis is other than GAAP. • Failure to appropriately modify the accountant's report to reflect financial statement titles that are appropriate for tax-basis financial statements.	• Inadequate description of the basis of accounting and how it differs from GAAP.

The current peer review model has as key objectives the promotion of consistency and efficiency, and improved transparency.

The current model has two types of peer reviews:

- **System Review** – This type of review is for firms that perform engagements under the SASs (audits) and/or examinations of prospective financial information under the SSAEs (attestation standards).

A system review focuses on a firm's accounting and auditing practice system of quality control design, policies and procedures in accordance with the quality control standards established by SQCS No. 8.

- **Engagement Review** – This type of review is for firms that are not required to have a system review (e.g., do not perform any audits (governmental or otherwise), or examination engagements under the SSAEs).

  The objective of an engagement review is to evaluate whether engagements submitted for review are performed and reported on in conformity with professional standards including *whether the reviewed firm's working paper documentation conforms with the requirements of SSARS applicable to those engagements in all material respects*. There is no opinion on the reviewed firm's system of quality control and therefore the reviewer is not opining on the firm's compliance with its own quality control policies and procedures or with quality control standards, just conformity with SSARS and the SSAEs.

  Engagement reviews include compilations that omit substantially all disclosures as well as management-use only compilations in which no compilation report is issued.

  The following table summarizes the current peer review structure:

Type of Peer Review Required	Highest Level of Service Conducted by Firm
System review--An opinion given on the firm's system of quality control.	Audits and/or examinations of prospective information (attestation engagements).
Engagement review-- Consists of: • Separate report, letter of comments, technical review actions apply. • Committee acceptance and monitoring. <u>Additional requirements</u>: workpaper documentation is in conformity with the SSARSs and/or SSAEs. Examples include management representation letter, documentation of matters covered in the accountant's inquiry and analytical procedures, etc.	Firms that are not required to have a system review. Example: • Reviews • Compilations including management-use only compilation engagements.

Current measurement standards:

The current peer review program includes terms to measure the quality of the peer review engagement:

- Matter
- Finding
- Deficiency, and

- Significant deficiency

A peer reviewer identifies a *matter* as a result of his or her evaluation of the firm's system of quality control. A matter warrants further consideration by the reviewer and is documented on a Matter for Further Consideration (MFC) form.

System review:

A *finding* is one or more related matters that result from a condition in the firm's system of quality control or compliance with that system that provides more than a remote possibility that the firm would not perform and/or report in conformity with professional standards.

If there is one or more findings, the peer reviewer concludes whether individually or combined, the findings rise to the level of either a deficiency or significant deficiency.

A finding that does not rise to the level of deficiency or significant deficiency is documented on a Finding for Further Consideration (FFC) form and is not included in the final peer review report.

A *deficiency* is one or more findings that the peer reviewer concludes that taken as whole, *could create a situation* in which the firm would not have reasonable assurance of performing and/or reporting in conformity with professional standards on one or more important respects.

A *significant deficiency* is one or more deficiencies that the peer reviewer concludes results from a condition in the reviewed firm's system of quality control or compliance such that as a whole, does not provide the firm with reasonable assurance of performing and/or reporting in conformity with professional standards in all material respects.

Engagement review:

A *finding* is one or more related matters that the reviewer concludes result in financial statements or information, accountant's report, or procedures performed, not being performed and/or reported on in conformity with the professional standards.

If there is one or more findings, the peer reviewer concludes whether individually or combined, the findings rise to the level of either a deficiency or significant deficiency.

A *deficiency* is one or more findings that the peer reviewer concludes that taken as whole, are material to the understanding of the financial statements or information and/or related accountant's reports or that represent omission of a critical procedure, including documentation, required by professional standards.

A *significant deficiency* exists when the peer reviewer concludes that deficiencies are evident on all of the engagements submitted for review. The exception is when more than one engagement has been submitted for review, the exact same deficiency occurs on each of those engagements, and there are no other deficiencies, which ordinarily would result in a report with a peer review rating of pass with deficiencies.

There are three (3) types of final reviewer reports that can be issued:

Pass: There were no deficiencies or significant deficiencies.
Pass with deficiency: There was one or more deficiencies but no significant deficiencies.
Fail: There was one or more significant deficiencies.

Other changes:

There are several other important requirements under the current peer review program.

a. The initial selection of engagements to be reviewed should be provided by the peer reviewer to the reviewed firm *no earlier* than three weeks prior to the commencement of the peer review procedures.

    - At least one engagement from the initial selection should be provided to the firm once the peer review begins and not provided in advance. The selection should be an audit or the next highest level of service.

b. The reviewed firm must provide a representation letter to the peer reviewer.

    - The representation regarding compliance is stipulated as negative assurance.

    - A firm's refusal to furnish a written representation letter to the reviewer constitutes a limitation of the peer review.

    - The letter must state that the accountant has submitted all engagements to the reviewer.

c. A firm's due date for its initial peer review is 18 months from the date it enrolled in the program. Subsequent peer reviews have a due date of three years and six months from the year end of the previous peer review.

Recent developments in peer review

There have been several changes made to peer reviews that practitioners should understand.

Development 1: Reports on service organizations now included under a system review:

Firms that perform engagements under the SASs or examinations of prospective financial statements under the Statements on Standards for Attestation Engagements (SSAEs) must undergo a system review.

SSAE No. 16, *Reporting on Controls at a Service Organization*, was issued and superseded SAS No. 70 dealing with an examination of the controls of a service organization. Effective in 2017, SSAE No. 16 is superseded by SSAE No. 18, *Attestation Standards: Clarification and Recodification*.

Therefore, reports of a service organization's controls issued under SSAE No. 18 are subject to a system review, and not an engagement review.

Development 2: Carrying broker-dealer engagements are now must-select engagements

If there is an audit involving carrying broker-dealers, the peer reviewer must treat that engagement as a must-select engagement in a system review.

1. Regulatory and legislative developments have made it clear that there is a significant public interest in, and a higher risk associated with, audits of broker-dealers. The type of broker-dealer with the highest risk is a carrying broker-dealer.

2. If a firm performs an audit of one or more carrying broker-dealers, at least one such carrying broker-dealer audit engagement should be selected for review.

3. If a firm‘s audits of broker-dealers include only non-carrying broker-dealers, the team captain should be aware of and give special consideration to the risks associated with such broker-dealer audits in making engagement selections.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. Engagement deficiencies where the engagement is considered to be a significant engagement deficiency include which of the following:
   a. Departure from standard wording where the report contains the critical elements of applicable standards
   b. Issuance of an audit report when the accountant is independent
   c. Failure to indicate in the audit report the country of origin
   d. Including excess disclosures related to significant accounting policies applied

2. Specific financial statement deficiencies noted in peer reviews related to the Statement of Income include which one of the following:
   a. Income tax provisions not recorded on annual financial statements
   b. Reporting period not clearly identified
   c. Insignificant components of income tax expense not disclosed
   d. Errors in calculations of totals

3. Which of the following is a deficiency listed for engagements subject to government auditing standards:
   a. Missing reports for internal control or compliance
   b. Too much compliance testing was performed
   c. Inadequate titles used on reports
   d. Using an audit program formatted for a non-governmental audit.

4. Which of the following is one of the two types of peer reviews under the AICPA peer review program:
   a. System review
   b. Document review
   c. Findings review
   d. Report review

5. A system review focuses on which of the following:
   a. Working paper documentation
   b. Management representation letter
   c. The accountant’s inquiry and analytical procedures
   d. The accounting firm’s system of quality control

6. Under the AICPA peer review program, which of the following engagements would require an engagement review to be performed assuming no other engagement is performed by the firm:
   a. Review
   b. Governmental audit
   c. Financial forecast
   d. Audit

7. If there is one or more findings, a peer reviewer may conclude that the finding(s) rises to the level of which of the following:
   a. Matter
   b. Deficiency
   c. Violation
   d. Fraud

8. With respect to the *AICPA peer review program*, which of the following is correct regarding the firm's representation letter:
   a. There is no requirement for the firm to provide a representation letter
   b. A signed representation letter must include positive assurance that the firm is in compliance with state board or other regulatory requirements
   c. A firm's refusal to furnish a written representation letter to the reviewer does not constitute a limitation of the peer review
   d. A representation must be made stating that the accountant has submitted all engagements to the reviewer

SUGGESTED SOLUTIONS

1. Engagement deficiencies where the engagement is considered to be a significant engagement deficiency include which of the following:
   a. Incorrect. A departure in the standard wording where the report does not contain the critical elements of applicable standards is an example, not where the report contains critical elements.
   b. Incorrect. Issuing an audit report when the accountant is not independent is a significant deficiency.
   c. Correct. One identified deficiency is the failure to indicate the country of origin in the report. It is considered a minor deficiency, and not a significant deficiency.
   d. Incorrect. Omitting disclosures, not including excess disclosures, related to significant accounting policies is considered a significant deficiency.

2. Specific financial statement deficiencies noted in peer reviews related to the Statement of Income include which one of the following:
   a. Incorrect. One deficiency is where income tax provisions were not recorded on interim financial statements, not annual statements.
   b. Correct. The peer review committee has noted that one specific deficiency is where the reporting period was not identified such as, for example, annual financial statements were not identified as "year ending December 31, 20xx."
   c. Incorrect. Significant (not insignificant) components of income tax expense were not disclosed.
   d. Incorrect. Errors in calculations of totals was not listed as a significant deficiency noted by peer reviewers regarding the Statement of Income.

3. Which of the following is a deficiency listed for engagements subject to government auditing standards:
   a. Correct. An auditor of a governmental entity is required to report on internal control. One specific deficiency noted regarding engagements subject to government auditing standards was that there were missing reports for internal control or compliance.
   b. Incorrect. One deficiency noted was that inadequate compliance testing was performed, not too much, making the answer incorrect.
   c. Incorrect. Having inadequate titles is not a listed deficiency regarding engagements subject to government auditing standards.
   d. Incorrect. Using an audit program formatted for a non-governmental audit is not one of the deficiencies noted. Using outdated materials is one of the deficiencies, but using the wrong audit program is not.

4. Which of the following is one of the two types of peer reviews under the AICPA peer review program:
   a. Correct. The two types are system and engagement reviews.
   b. Incorrect. The two types are system and engagement reviews. Document review is not one of the two.
   c. Incorrect. A findings review is not one of the two types of peer reviews.

d. Incorrect. Under the peer review program, a report review is not one of the two types of reviews. A report review was a type of review under the previous AICPA peer review program, but is not under the current program.

5. A system review focuses on which of the following:
   a. Incorrect. Working paper documentation is the focus of an engagement review, not a system review.
   b. Incorrect. Obtaining a management representation letter is an effort that a peer reviewer would consider in an engagement review and not a system review.
   c. Incorrect. The accountant's effective use of inquiry and analytical procedures is an integral part of an engagement review and not a system review.
   d. Correct. A system review encompasses opining of whether a firm is in compliance with its own quality control policies and procedures.

6. Under the AICPA peer review program, which of the following engagements would require an engagement review to be performed assuming no other engagement is performed by the firm:
   a. Correct. A review engagement would require a firm to be subject to an engagement review.
   b. Incorrect. A governmental audit elevates the firm to the requirement that it be subject to a system review and not an engagement review.
   c. Incorrect. A financial forecast, which is performed under the SSAEs, elevates the firm to the requirement that it be subject to a system review and not an engagement review.
   d. Incorrect. An audit, which is performed under the SASs, elevates the firm to the requirement that it be subject to a system review and not an engagement review.

7. If there is one or more findings, a peer reviewer may conclude that the finding(s) rises to the level of which of the following:
   a. Incorrect. A matter is an item that warrants further consideration and is not a finding.
   b. Correct. A finding(s) may result in either a deficiency or a significant deficiency.
   c. Incorrect. The peer review program does not use the term "violation."
   d. Incorrect. Fraud is used as a term in an audit but is not referenced in the AICPA peer review program.

8. With respect to the *AICPA peer review program,* which of the following is correct regarding the firm's representation letter:
   a. Incorrect. The reviewed firm must provide a signed representation letter to the reviewer that includes certain representations.
   b. Incorrect. The representation regarding compliance is stipulated as negative assurance rather than positive assurance.
   c. Incorrect. A firm's refusal to furnish the written representation letter to the reviewer constitutes a limitation of the peer review.
   d. Correct. The representation letter must state that the accountant has submitted all engagements to the reviewer, making the answer correct.

SECTION 2: Accounting and Auditing in Volatile Times

XII. Key Focus Areas for the Auditor

In conducting attest services, auditors should be aware of some of the key areas in which they should focus their efforts to deal with the volatility in the business climate.

1. Inquire as to the status of concentrations of customers and suppliers:

Auditors should consider the risk associated with maintaining a concentration of business with a handful of customers or a single supplier of an important material. Although ASC 275, *Risks and Uncertainties* (formerly SOP 94-6), requires disclosure of concentration of major customers and suppliers when it is reasonably possible that the concentration could result in a near-term (within one year) severe impact on a company, it is important that the auditor consider the solvency of the customer and supplier and whether that company might be in financial trouble.

2. Pay attention to key financial ratios and analytical procedures:

If a company is in financial trouble, the signs will be there for the auditor to observe. Analytical procedures present critical signs of trouble well before the company is in severe financial decline.

What ratios and analytical procedures are important?

There are many ratios that are important. The auditor should focus on *liquidity and coverage ratios* since they display the short-term (within one year) trend of a company.

a. Working capital ratios:

Four key ratios provide a thorough analysis of working capital. They are:

$$\text{Days Sales in Accounts Receivable} = \frac{\text{Trade receivables}}{\text{Net sales}} \times 365$$

$$\text{Days Supply in Inventory} = \frac{\text{Inventory}}{\text{Net sales}} \times 365$$

$$\text{Days Payables Outstanding} = \frac{\text{Accounts payable}}{\text{Net sales}} \times 365$$

$$\text{Days in Working Capital} = \frac{\text{AR + Inventory – AP}}{\text{Net sales}} \times 365$$

Observation: The first sign that a company is headed toward cash flow problems is usually found in a spike in the number of days in receivables. Typically, the number of days increases by 2 to 7 days driven by an increase in that portion of receivables that exceed 60 days old.

For example, a company that typically has a number of days of 42 will start to see that number increase to 45 or 46 days.

b. Other coverage ratios:

Times debt service is earned:

$$\frac{\text{Net income before interest, depreciation and amortization}}{\text{Current annual principal and interest payments}}$$

Interest coverage ratio:

$$\frac{\text{Cash flow from operations + interest}}{\text{Interest}}$$

Note: Both of the above ratios should exceed 1.0. In instances where the ratio is below 1.0, there is the risk that the company may not be able to fund debt service and could become in default of its loan agreements.

c. Altman Z Score- Consists of a weighted average of four separate ratios as follows:

Ratio 1: $\frac{\text{Working Capital}}{\text{Total assets}}$

Ratio 2: $\frac{\text{Retained earnings}}{\text{Total assets}}$

Ratio 3: $\frac{\text{Net earnings before interest and income taxes}}{\text{Total assets}}$

Ratio 4: $\frac{\text{Net worth}}{\text{Total debt}}$

All four ratios are weighted to compute an overall Z score as follows:

6.56 (ratio 1) + 3.26 (ratio 2) + 6.72 (ratio 3) + 1.05 (ratio 4) = Z score

Results:
1.00 or less: Headed toward bankruptcy
1.01 to 2.50: Could have financial problems
2.50 or greater: Strong financially, unlikely risk of bankruptcy

Observation: The Altman Z Score is generally accepted as a ratio that is highly correlated with bankruptcy. It works on companies within most traditional industries such as retailers, wholesalers and manufacturers. For others, such as real estate developers and certain highly leveraged industries, the Altman Z Score may show a distorted result due to the disproportionate amount of debt that may be outstanding at a particular point in time.

In most engagements involving strong, solvent companies, the Altman Z ratio usually generates a score in the 5.00 to 9.00 range. Many leading accounting software packages include the Altman Z score as part of the analytical procedures (ratios). The author recommends that practitioners compute the Altman Z Score for all engagements including audits, reviews and compilations as the accountant/auditor has a responsibility for going concern in each of those types of engagements.

3. Check for going concern:

SAS No. 122, AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* (formerly SAS No. 59), provides guidance on evaluating the adequacy of going-concern disclosure in audited financial statements. AU-C 570 is the only authoritative auditing literature for going concern disclosure. Continuation of an entity as a going concern is assumed in financial reporting in the absence of information to the contrary.

Determining whether there is a going concern problem is based on the facts and circumstances of the case. Factors to consider include:

- Unusually liberal credit terms to customers including dating of receivable
- Continued operating losses
- Negative cash from operations in statement of cash flows
- Company is running tight on its working capital line of credit formula
- Weak financial ratios such as the Altman Z Score

Rule under AU-C 570 (formerly SAS No. 59):

> In an audit engagement, if there is *substantial doubt* of an entity's ability to continue as a going-concern for *one year from the balance sheet date*, the CPA *must seek factors that mitigate* this fact such as alternative sources of financing, management's plan of action, etc.
>
> If, after seeking mitigating factors, the auditor still believes there is *still substantial doubt***,** The SAS requires a disclosure and an audit report modification as follows:

Separate paragraph in the audit report:

> As discussed in Note A, the Company has suffered continued losses from operations and, at December 31, 20X1, has a deficiency in stockholders' equity. These factors raise substantial doubt about the Company's ability to continue as a going concern. Management has a plan of action that is described in Note A. The financial statements do not reflect any adjustments that might result from the outcome of this uncertainty

4. Check loan covenants and restrictions:

Due to the status of the credit markets in 2016, lenders have continued to tighten up lending criteria. As loans come due, lenders may try to renegotiate credit terms. The result is that auditors should be aware of the risks associated with obtaining and retaining financing, particularly with respect to marginally profitable companies.

a. Companies with existing financing that is up for renewal may find greater restrictions placed on them by their bankers including the requirement for additional collateral and more stringent performance ratios and covenants.

b. Commercial real estate loans may require an infusion of cash by the owner because of declines in real estate values.

Auditors need to consider the impact of lower cash flow on loans in terms of how they will impact loan covenants, and whether the entity can fund cash flow.

5. Be aware of client pressures to reverse allowance and reserve accounts:

Some companies treat their allowance accounts and reserve for inventory obsolescence to be "rainy day funds." Throughout the past decade, many auditors have left excess amounts in selected reserve and allowance accounts based on the argument that higher allowance or reserve account balance reflected a lower, more conservative net income. If a company is experiencing a decline in profitability, there may be an attempt by management to reduce those accounts to their lower, actual estimated balances with a corresponding credit to an expense or cost of sales. Such an entry results in a credit to net income, most of which relates to prior years. Auditors should consider whether such entries, if any, are material.

6. Inventory obsolescence:

As previously discussed in this course, many companies have gradually cleaned up their excess inventory levels, leading to a demand for additional orders which may be the catalyst for economic growth. However, many companies are still holding onto older slower-moving, obsolete items. Auditors should consider the possibility that a reserve for obsolescence might have to be set up or increased to accommodate the obsolete goods.

7. Impairment issues- real estate:

Real estate has been valued at record high levels due to low capitalization rates fueled by low interest rates. Auditors should be aware of the risks that real estate might be impaired, requiring a write down in accordance with ASC 360, *Property, Plant and Equipment* (includes former FASB No. 144). The writedown may be the result of two causes. First, commercial real estate may be overpriced due to high commercial vacancies. Second, as interest rates climb capitalization rates used to value real estate will increase, resulting in lower real estate values.

Note further that many bank loans have “call” provisions under which the banker may take action if the value of the real estate declines. Action may include either requiring the borrower to infuse

additional cash to keep the loan in equilibrium with the original loan-to-value, or may allow the borrower to call the loan.

8. Writedowns of investment values:

Companies that have investments in securities may have experienced declining stock values. Additionally, companies may be holding investments in nonsecurities, such as a closely held stock or partnership investment.

In such instances, the auditor should consider the accounting for any potential declines in values.

ASC 320, *Investments in Debt and Equity Securities* (formerly FASB No. 115), addresses the accounting for securities by categorizing securities into three categories.

The **three (3) categories** are as follows:

> Debt securities held-to-maturity- Debt securities that management plans to hold until maturity.
>
> Trading securities- Both debt and equity securities that are bought and held for the purpose of selling them in the near term (generally within one year).
>
> Available-for-sale- Both debt and equity securities that are not categorized as either held-to-maturity or trading securities, are automatically categorized as available for sale. In this category, management has essentially not decided what it plans to do with the securities.

The category in which a security is placed is determined at the time of purchase based on *management's positive intent and ability*. Once a security is placed in a particular category, it generally can be changed only where there are significant unforeseeable circumstances.

ASC 325, *Investment- Other* (formerly part of ARB No. 43), addresses the accounting for investments not covered by FASB No. 115, namely non-security investments, including investments in closely held businesses. ASC 325 states that such non-security investments should be recorded at amortized cost.

Decline in the investment value that is other-than-temporary:

Regardless of whether there is an investment in securities (publicly traded bonds or stocks) or non-securities (closely held investments), there is an overriding rule found in ASC 320, *Debt and Equity Securities* (formerly FASB No. 115) and ASC 325 (formerly ARB No. 43), that deals with a decline in the value of an investment that has an unrealized loss that is other than temporary.

Specifically, if there is a decline in value that is other than temporary, the amortized cost should be *written down to fair value and a realized loss should be recorded on the income statement*. The fair value becomes the new cost basis going forward to the next year. Once written down to fair value, in future years, the value may not be written back up to the original cost.

What does other-than-temporary mean?

ASC 320 (formerly FASB No. 115) gives an example of where the "other-than-temporary" threshold might be met with respect to a debt security:

> *"If it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred."*[29]

Examples of factors that might suggest an other-than-temporary impairment has occurred are as follows:

1. Fair value is significantly below amortized cost.

2. There has been a decline and it is attributable to adverse conditions specific to the security or the industry or its geographic area, and the decline has existed for an extended period of time.

3. A decline exists and management does not have the intent and ability to hold the security for a period of time sufficient to allow the security to recover its value. If it is a debt security, management does not plan to hold the security until maturity.

4. A security has been downgraded by a rating agency or the financial condition of the security issuer is known to have deteriorated.

5. The issuer has reduced or eliminated dividend payments, or has not made required interest payments.

6. The issuer has recorded losses from the security after year end.

What is the value of a security or non-security investment?

Determining the value of a security is much easier than that of a non-security investment. A security (debt or equity) typically has a readily determinable market value that is published. Nevertheless, regardless of the type of investment, the fair value is a compilation of various factors including:

- The issuer's financial condition and performance including the quality of assets, earnings trends, and other financial factors

- The prospects within the industry and region, and

- Management's intent with respect to the investment.

[29] ASC 320 (formerly FASB No. 115).

With respect to investments in closely held entities, determining the fair value is more difficult because published information on the investee may not be available.

Auditing the investment writedown

SAS No. 122, AU-C Section 501, *Audit Evidence- Specific Considerations for Selected Items* (formerly SAS No. 92), provides authoritative guidance on how to audit investments in securities. Similar guidance should be followed for auditing investments in non-securities.

Specific requirements in AU-C 501 include:

a. If a writedown has been made, make sure it is recorded as a realized loss on the income statement

b. Test the loss computation

c. Ensure that previously written-down losses have not subsequently been written back up

d. Make sure that the summary of written down investments is complete and accurate

e. Consider the credit rating of the counterparty, and

f. Conclude on the adequacy of the impairment writedown and adjustment.

9. Watch out for round-trip transactions:

The use of round-trip or "wash" transactions can artificially inflate revenues and profits by creating a flow of funds that circulates back to the company in a different form from when it was initially disbursed by the company.

The *AICPA's Audit Risk Alert* gives an example of how round-trip transactions occur to inflate an entity's revenue.

Step 1: Company A pays an inflated amount to a vendor for services or products.
Step 2: The vendor buys products or services from Company B.
Step 3: Company B buys products or services from Company A.
Step 4: Company A records the sale to B as revenue.

The result is that Company A has inflated revenue from the transaction even though the transaction might be a profit wash in that Company A has additional revenue and additional cost from the payment to its vendor. However, by inflating revenue, Company A may be able to make the case to a third-party investor or financer that the Company's revenue base is growing.

Auditors and accountants should be aware of the above transactions that lack economic substance.

10. Look for games being played with expenses:

If management is not playing games with revenue, it might attempt to manipulate expenses as a means to augment an entity's profitability. Here are a few ways in which management might attempt to manipulate expenses:

- Expenses are capitalized despite no evidence of future benefit beyond the current reporting period
- Increasing salvage values and useful lives of depreciable assets
- Not accruing expenses that should be accrued
- Not writing off costs capitalized on aborted projects
- Recording liabilities and related expenses in the wrong period
- Under or overstating asset allowance accounts including allowance for bad debts and obsolete inventories
- Netting expenses and revenue where there is no legal right of offset, and
- Misclassifying expenses on the income statement above or below the line.

11. Check for "slush-fund" reserves and "rainy day" funds and distorted estimates:

During difficult financial times, management may take a posture to manipulate financial statements from one end or the other:

a. Management may feel pressure to meet projections, thereby understating allowances and reserves to achieve financial goals.

b. Management may also decide that it has sufficient income for the current year and might "save" extra income for the next year by understating income using excess reserves, accruals and allowance balances.

Similarly, in a year of a significant loss, management might decide to increase the loss by increasing allowances and reserves, thereby saving income for future years.

Example: Company X has a large loss in the current year. X decides that there would be no impact if the loss was even larger. Thus, X increases its loss by increasing both the allowance for bad debts and allowance for obsolete inventory.

In the next year, X reverses the overstated amount in the allowance accounts and credits them to expense and cost of sales.

Conclusion: X has played the game of using slush funds to manipulate income from year to year.

Auditors and accountants can sometimes focus on the wrong end of management's objectives. Because the concept of conservatism is embedded in the accounting psyche, auditors and accountants may permit management to overbook reserves and allowances based on the concept that "a more conservative net income is better." However, by doing so, the auditor or accountant is being set up for a potential problem in future years in which management decides to reverse the accruals, allowances and reserves, thereby artificially inflating future years' income.

The concept of using "rainy day" funds has been around for quite a while, yet the focus on them in recent years is relatively new for auditors and accountants.

Auditors and accountants need to understand the underlying assumptions used in management's estimates for accruals, allowances and reserve accounts and must review any changes in estimates to determine that they are reasonable, and that they are supported with sufficient evidential matter.

In assessing the assumptions used by management to develop estimates, auditors and accountants should consider whether:

- The assumptions used are consistent with the sources from which they were derived
- The assumptions are consistent with management's plans
- The information used is reliable
- There were sufficient sources of information used to develop the estimate

12. Look at underfunded pensions and post-retirement benefit obligations:

Many pension funds are now underfunded even though many defined benefit and post-retirement benefit obligations were overfunded less than a decade ago.

The results can be significant:

- Newly required funding may deplete future cash flows and affect profitability.
- The required funding may affect loan covenants.

Additionally, management might alter actuarial assumptions in order to minimize the obligation to be recorded.

a. With the drop in interest rates, management might attempt to discount the obligation using a higher-than-market interest rate. A higher rate will yield a lower present value of benefits obligation.

b. Management may change employee retention and participation rates as well as the amount and timing of the future benefit payments.

13. Auditors may wish to assist clients in tightening up operations:

In all business cycles, accountants and auditors can assist clients in tightening up operations by performing two services:

a. Expense reduction review and performance review

b. Profitability analysis on customers and product lines

Expense reduction involves performing an analysis of the efficiency of operations including labor and operating expenses. The objective is to identify where a company can reduce costs that may have bloated gradually over a long period of time.

Profitability analysis entails performing a vertical analysis of each major customer or product line to ascertain whether certain customers or lines should be eliminated altogether.

The 80-20 rule is an important one. That is, 80% of a company's profitability comes from 20% of its customers or products. The remaining 80% of the customers or products generate only 20% of the company's profitability. Some of the 80% can be eliminated altogether from the client's business.

Consider the following example of a client of the author who asked for assistance in evaluating the profitability of its major customers.

Facts: The client asks the author to assist in an analysis of certain larger customers. The client is concerned that the larger customers are "squeezing" the client on sales prices to the extent that the business may no longer be profitable.

	------Customer X------		Company Total
Sales	$8,000,000	100%	100%
Direct costs: direct labor, materials and variable overhead, and variable selling costs	(5,800,000)	(72)%	(48)%
Contribution margin	2,200,000	28%	52%
Fixed overhead	(2,360,000)	(30)%	(30)%
Net income- absorption cost	$(160,000)	(2)%	22%

Should the client stop doing business with the customer with whom he is losing $(160,000)?

Conclusion: The previous analysis is a traditional direct-cost analysis whereby a contribution margin (sales less variable costs) is calculated to determine the amount being contributed to fixed overhead.

Other types of analyses can be performed such as activity-based accounting.

Using the previous analysis, assuming that no other factors are significant, Company X is actually profitable since there is a contribution to fixed overhead in the amount of $2.2 million. If the client stops doing business with Customer X, other business must be developed to pay for the $2,200,000 of fixed overhead that it absorbs. The exception is where there is a limit in the amount of business it can accommodate, and the company has other, more profitable business that can replace Customer X's business.

The previous analysis can be done on all significant customers or product lines to eliminate marginally profitable business.

14. Watch out for related-party transactions:

If a company is experiencing a downturn in its business, there may be an incentive to use related-party transactions to disguise the true financial situation. Here are a few:

a. Specific abuses in related-party transactions:

The auditor or accountant may encounter transactions with related parties that either lack economic substance or are not disclosed. Example include:

Sales and expenses:

- Sales without economic substance, such as round-about transactions in which the entity loans money to an affiliate who, in turn, remits it in a sales transaction.
- Sales that do not result in the risks and rewards of ownership passing to the related party purchaser (e.g., right to return the goods, a commitment by the seller to repurchase the goods, etc.).
- Sales or purchases among related parties at little or no cost.
- Sales recorded from a related party for services never rendered.
- Sales to a related party middleman at a below-market price. The middleman then sells to the ultimate customer at a higher price while the related party retains the difference.
- Having one party pay the expenses and costs for another related party.
- Large, unusual transactions with related parties near or at year end.

Loans:

- Loans between entities on an interest-free basis or at an other-than market rate, or that have no scheduled terms of repayment.

- Loans that have an unusually high interest rate and the resultant higher interest income.

- Loans to entities that do not have the ability to repay them.

- Advances of company funds to a related party who, in turn, uses the funds to repay an otherwise uncollectible loan or receivable.

- Loans made to a related party and subsequently written off.

- Forgiveness of a loan so that the debtor can recognize extinguishment of debt income.

Note: A comment made by peer reviewers is that auditors and accountants do not consider the collectability of intercompany receivables. The auditor should consider the viability of the affiliate and whether the loan is collectible. If not, an allowance may have to be established.

Moreover, in certain situations involving related party debt, ASC 470, *Debt* (formerly found in APB No. 26), clearly states that *"the extinguishment transactions between related parties may be, in essence capital transactions."* Thus, depending on the extent to which there are related parties, any forgiveness should be credited to equity as additional paid in capital. Recording the transaction as forgiveness of debt income on the income statement would not be appropriate given the related party nature of the loan.

Asset transactions:

- Purchasing assets from a related party at above-market prices

- Selling real estate at an amount that is significantly different than the appraisal or market value

- Exchanging similar property in a nonmonetary transaction

- Sale of land with arranged financing

- Sale of marketable securities at a discount from quoted market prices

b. What an auditor should do about related-party transactions:

The AICPA's *Audit Risk Alert* makes some recommendations about how an auditor can deal with related party transactions.

Searching for related party transactions:

- Review material cash disbursements and other transactions

- Discuss with tax and consulting personnel who have provided services to the client whether they are aware of any related party transactions

- Discuss with other professionals (lawyers, predecessor auditors) about related parties

- Use the Internet to search records for the names of principals of the audit client to find other affiliated entities

Auditing known related party transactions:

Once the auditor has discovered a related party transaction, he or she might wish to perform some or all of the following procedures.

- Develop an understanding of the business purpose of the transaction(s)

- Examine evidence related to the transaction(s) including invoices, copies of agreements, contracts, and other documents (receiving and shipping reports, etc.)

- Obtain evidence that the transaction(s) was approved by the board of directors or other management

- Test the adequacy and accuracy of the related party disclosure

- Make sure that there are concurrent audits of intercompany balances and that information is obtained for such balances at the same time
- Examine or confirm evidence about the transferability and value of collateral

- Confirm transaction terms and amounts such as guarantees and other information, with the other party to the transaction

- Examine or inspect evidence in the hands of the other party to the transaction

- Discuss significant information with other third parties including banks, attorneys, agents, etc.

- Review financial publications, trade journals, credit agencies, etc. and other sources when there is concern that related party transactions lack economic substance

- Examine the financial statements, tax returns, and other information of related parties, if such information is available.

Observation: The auditor should be careful that related party disclosures are not misleading. In general, a related party disclosure should not express or imply that the transactions were arms-length unless such a claim can be substantiated.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. Which of the following is the formula for the *Days Sales in Accounts Receivable* ratio:
   a. $\frac{Accounts\ \ Payable}{Net\ Sales} \times 365$
   b. $\frac{Accounts\ \mathrm{Re}ceivable + Inventory - Accounts\ Payable}{Net\ Sales} \times 365$
   c. $\frac{Inventory}{Net\ Sales} \times 365$
   d. $\frac{Trade\ \mathrm{Re}ceivables}{Net\ Sales} \times 365$

2. If a company has an Altman Z Score of 2.50 or greater, that company:
   a. Could be in default of its loan agreements
   b. Could have financial problems
   c. Is headed toward bankruptcy
   d. Is strong, with an unlikely risk of bankruptcy

3. Which of the following factors might suggest that an other-than-temporary impairment has occurred in a security investment:
   a. A rating agency has upgraded a security
   b. Amortized cost is significantly below fair value
   c. Losses are recorded from the security after year end
   d. Management intends to hold the security to allow a value recovery

4. Auditors should be aware of _____ that circulate a flow of funds back to the company in a different form than the company initially disbursed.
   a. Investment writedowns
   b. Manipulation of expenses
   c. Round-trip transactions
   d. Slush-fund reserves

5. In what way can accountants and auditors help clients tighten up operations:
   a. Use the 50-50 rule with respect to evaluating a company's profitability
   b. Horizontal analysis of major customers
   c. Analysis of product lines' profitability
   d. Absorption cost review

SUGGESTED SOLUTIONS

1. Which of the following is the formula for the Days Sales in Accounts Receivable ratio:
   a. Incorrect. The formula for Days Payables Outstanding is $\frac{Accounts\ \ Payable}{Net\ Sales} \times 365$
   b. Incorrect. The formula for Days in Working Capital is

   $$\frac{Accounts\ \mathrm{Re}ceivable + Inventory - Accounts\ Payable}{Net\ Sales} \times 365$$

   c. Incorrect. The formula for Days Supply in Inventory is $\frac{Inventory}{Net\ Sales} \times 365$
   d. **Correct. The formula for Days Sales in Accounts Receivable is:**
   $$\frac{Trade\ \mathrm{Re}ceivables}{Net\ Sales} \times 365$$

2. If a company has an Altman Z Score of 2.50 or greater, that company:
   a. Incorrect. Where the ratios for Times Debt Service is earned and Interest Coverage are below 1.0, there is a risk that the company may not be able to fund debt service and could default on its loan agreements. An Altman Z score of 2.50 or greater has nothing to do with whether an entity is in default on a loan.
   b. Incorrect. If a company has an Altman Z Score of 1.01 to 2.50, that company could have financial problems, but generally not so if the ratio is 2.50 or greater.
   c. Incorrect. If a company has an Altman Z Score of 1.00 or less, that company is headed toward bankruptcy.
   d. **Correct. If a company has an Altman Z Score of 2.50 or greater, that company is strong financially, with an unlikely risk of bankruptcy.**

3. Which of the following factors might suggest that an other-than-temporary impairment has occurred in a security investment:
   a. Incorrect. The fact that a rating agency has downgraded, not upgraded, a security rating may suggest there is an impairment.
   b. Incorrect. If fair value is significantly below cost, there could be an impairment, not the other way around.
   c. Correct. If losses are recorded after year end, an other-than-temporary impairment might have occurred and been in place at year end.
   d. Incorrect. If management has both the intent and ability to hold the security for enough time for its value to recover, it is not likely that there is an impairment. Instead, if management *does not* have the intent or ability to hold the security for a period of time sufficient to allow the security to recover its value, an other-than-temporary impairment might have occurred.

4. Auditors should be aware of _____ that circulates a flow of funds back to the company in a different form than the company initially disbursed.
   a. Incorrect. Investment writedowns have no flow of funds back to the company.

b. Incorrect. Manipulation of expenses may impact the income statement but has no direct effect on the circulation of flow of funds back to the company.
c. Correct. Auditors should be aware of round-trip transactions that create a flow of funds that circulate back to the company in a different form from when it was initially disbursed by the company.
d. Incorrect. Slush fund reserves result in the manipulation of income from period to period but do not affect funds flow.

5. In what way can accountants and auditors help clients tighten up operations:
   a. Incorrect. Typically, an 80-20 rule is used, not 50-50. The 80-20 rule is important to consider when performing a profitability analysis: 80% of a company's profitability comes from 20 % of its customers or products.
   b. Incorrect. A vertical analysis is used, not a horizontal one. Profitability analysis entails performing a *vertical* analysis of each major customer or product line to ascertain whether certain customers or lines should be eliminated altogether.
   c. Correct. One of the two ways that accountants and auditors can help clients tighten up operations is through profitability analysis of customers and product lines.
   d. Incorrect. Generally, an absorption cost review is not one of ways identified to tighten up operations.

XIII. Lessons From Litigation

A. Introduction

In recent years, we have seen tremendous growth in litigation claims that has expanded throughout all segments of society. In particular, the professions have seen increases in claims at an exponential level. Doctors, lawyers, architects and accountants have all experienced the threat of a lawsuit from a client or third party, whether frivolous or not. The result has been skyrocketing malpractice insurance premiums.

With accountants, the highly publicized cases against the national CPA firms represent a small percentage of the overall claims against accountants. More and more claims are being initiated by smaller, closely held business owners, along with a significant increase in the number of claims made by third parties. The average claim against accounting firms is settled in the range of $100,000- $250,000.

Given the weakening of the third-party privity defense in most states, accountants continue to be exposed to third-party lawsuits, despite the fact that there is no contract between the accountant and the third party.

Most malpractice insurance companies concede that lawsuits against accountants now come from sources once thought to be unlikely.

Consider the following summary compiled by the author through interviews with several top malpractice insurance companies:

1. There is a significant increase in lawsuits initiated by third parties such as bankers and trustees:

    - 15% of lawsuits are initiated by third parties
    - 85% of lawsuits are initiated by clients

2. A significant portion of lawsuits relate to non-traditional tax and audit services such as:

    - Compilations and review engagements
    - Writeup engagements
    - Management advisory services

3. Most lawsuits occur *within the first five years* of the auditor's relationship, with most of the litigation revolving around the first year.

4. Approximately 20-25 percent of all claims against accountants relate to compilation and review engagements.

5. The courts tend to hold accountants responsible well beyond the standards applicable to the engagement:

- The complexity of facts in lawsuits has increased, making it difficult to defend in front of a jury.

- Juries do not understand the issues at hand in lawsuits- thereby pooling audit, review and compilation engagements under one level of responsibility.

- Juries tend to hold accountants to the level of guarantors.

- Many jury rulings imply that the accountant must go so far as to protect clients from themselves.

- Jury awards clearly demonstrate that there is a perception gap between what the public believes the accountant delivers and the actual service delivered.

- Accountants tend to be poor witnesses-- too precise and accurate to persuade a jury of the facts.

6. Competitive pressures have moved accountants into areas of greater risk whereby accountants are:

- Keeping or accepting higher risk clients
- Accepting engagements outside their areas of expertise
- Overselling their abilities to gain new clients
- Criticizing the predecessor firm after obtaining a client from that firm.
- Using a standard (canned) audit program instead of customizing program design for particular risk areas.

B. Common Pitfalls For Accountants

The following is a list of common pitfalls that continue to expose accountants to loss in litigation.

1. <u>Failure to maintain professional skills:</u>

- Not keeping up with CPE, professional journals and society programs, particularly in the area of accounting and auditing.

- Not using up-to-date manuals and checklists.

2. <u>Working in areas and industries outside of expertise:</u>

- Lack of familiarity with GAAP and GAAS.

- Not consulting with outside experts such as professional societies, AICPA, FASB and insurance-carrier hotlines.

- Not familiar with industry norms such as accounting methods, relationships, and credit policies.

3. <u>Unprofessional working habits:</u>

   - Failure to document work including:
     - Insufficient workpapers
     - Using canned programs rather than customized programs
     - Insufficient financial statement disclosures
     - Not documenting recommendations made to clients

   - Failure to notice the obvious-too much time looking at the trees and not the forest

4. <u>Failure to maintain a good relationship with clients:</u>

   - Not communicating a clear understanding of responsibilities to the client

   - Having a poorly drafted engagement letter

   - Overselling the firm's abilities and expertise: Using high-priced employees to sell the firm without introducing the junior staff who will actually work on the job.

   - Failure to communicate effectively:
     - Omitting information up front
     - Not being straight forward about areas of risk
     - Using too much jargon with terms such as GAAP, GAAS, etc.

   - Not being available to clients:
     - Not returning telephone calls promptly or at all

   - Agreeing to an unrealistic schedule by not saying "no" to a client

   - Maintaining an improper distance from your client:
     - Being too close may compromise independence
     - Being too far may result in lack of regular contact, failure to return calls, etc.

5. <u>Failure to properly hire and supervise staff:</u>

   - Not recognizing employee financial problems:
     - Staff may be vulnerable to client bribes or may steal from a client

   - Not recognizing employee personal problems such as alcohol and substance abuse, gambling and other addictions
     Note: Abusive personalities gravitate toward abuse during times of stress (e.g., audit and tax season)

- Not checking employee references

- Not emphasizing quality over quantity
  - A deterioration of quality in exchange for speed exposes the firm to the risk of errors.

- Not prohibiting employee moonlighting
  - Employees who moonlight may have poorer job performance during the day.
  - Employees who moonlight usually do not carry personal liability insurance.
  - The firm may be named as a co-defendant if the employee is sued, using the argument that the employee was working on behalf of the firm under apparent authority.

- Risks of using per diem employees
  - Not checking to ensure that per diem employees have adequate CPE in the area of the engagement.
  - Not properly overseeing the work of the per diem employees.
  - Being complacent that the per diem employees are "seasoned veterans" not requiring the same degree of supervision as the firm's other staff.
  - Accepting the "bad workpaper habits" of per diem employees.

6. <u>Conflicts of interest/independence issues:</u>

   - Bringing parties together of mutual interest
     - The accountant may be held liable for damages due to recommending one party to another.

   - Accepting referral fees and commissions
     - If commissions are received, independence may be impaired.
     - Not disclosing that a commission or referral fee will be received.

   - Getting in the middle of clients' disputes
     - There is a risk that one or both parties may sue the accountant for having a conflict of interest such as in the case of a divorce.

7. <u>Lowballing fees:</u>

   - Cutting corners on the engagement to accommodate the low fee.

8. <u>Suing clients for fees:</u>

   - More than 50% of all clients that are sued will file a counterclaim for malpractice.
   - Alleging negligence usually forces the accountant to drop the suit for fees.

9. <u>Failure to discover fraud and defalcations:</u>

   - Juries believe the auditor is responsible for finding fraud in audit, review and compilation engagements as well as write-up engagements.

- More pronounced in small companies with weaker segregation of duties.

- A single defalcation can be devastating to a smaller company as compared with a larger company. Damages against the accountant can be more significant if a smaller company is involved.

- Accountants do not recognize the fraud risk factors such as:
  - Lack of management integrity
  - Weak competitive position, tempting management to commit fraud
  - Lack of operational capabilities, including not enough personnel, machines, and resources
  - High turnover of accounting personnel
  - Firing of the previous accounting firm or a series of firms within several years
  - Board or key executive resignations
  - Changes in the way business is conducted including deep price discounts
  - Pressure to increase earnings particularly with start-ups and companies for sale
  - Pressure to satisfy loan covenants
  - Significant year-end transactions that favorably impact earnings
  - Related-party transactions
  - Lack of documentation for transactions
  - Weak internal controls
  - Using offsetting transactions that zero out
  - Loss of a major customer

- Employee defalcation factors: Employees who:

  - Live beyond their means
  - Never take a vacation
  - Are the first in and last out each day
  - Never share tasks
  - Never ask for a raise
  - Resist changes to existing bookkeeping methods
  - Offer superiors frequent examples of their loyalty and productivity

C. Top Ten Actions to Minimize the Risk of Being Sued

The following is a list of the *top ten actions to minimize the risk of being sued*. This list was compiled by the author as a result of various discussions with top malpractice insurance companies.

- Tighten Up Engagement Letters
- Watch Out for Bad Clients
- Take Precautions for Fraud and Defalcation
- Protect the Privity Defense Against Third Parties
- Supervise and Manage Personnel

- Have a Workpaper Retention Policy
- Improve Billing Procedures
- Never Sue to Collect Unpaid Fees
- Tighten Up Workpapers
- Improve Client Relations

Here is a discussion of just a few of the list of ten recommendations

Recommendation: Tightening Up Engagement Letters-Litigation-Friendly Clauses

To mitigate the effects of litigation against auditors, more accounting firms are including protective language in their engagement letters. The engagement letter is the contract between the client and the auditor and should clearly reflect the understanding and responsibilities of the parties.

SAS No. 122, AU-C Section 210, *Terms of Engagement* (formerly SAS No. 108),[30] provides a list of required and recommended language that should be included in an engagement letter. Excerpts from this statement are included below.

Examples of provisions to include in the engagement letter that might assist the auditor in litigation include:

1. Responsibilities for fraud- (AU-C 240 (formerly SAS No. 99)) requirements- required

2. Limitations on use or reproduction of the audit report for unknown third parties-recommended

3. Indemnification to the auditor from liability arising from management misrepresentations that result in legal fees incurred by the auditor- recommended

4. Ownership of workpapers- recommended

5. Mediation clause, but never an arbitration clause

Based on previous court decisions, reference to some or all of these items has been helpful in minimizing the damages against the auditor. Of course, the auditor must balance the need to include some or all of these provisions in his or her engagement letter, without alienating his or her client who may be reluctant to include them.

Sample Language To Be Included In The Engagement Letter:

> ***Fraud:***
>
> We will plan and perform the audit to obtain reasonable, but not absolute, assurance about whether the financial statements are free from material misstatement due to error

[30] Effective December 31, 2012, SAS No. 108 is replaced by AU-C 210, *Terms of Engagement.*

or fraud. Because of the concept of reasonable assurance and because we will not perform a detailed examination of all transactions, there is a risk that material errors, fraud, or other illegal acts, may exist and not be detected by us. Further, we have no responsibility to search for fraud and, our audit is not designed to detect an error or fraud that is immaterial to the financial statements.

Use of Report by Third Parties:

We understand that you have a loan outstanding with NoLoan Bank and Trust and that the purpose of our report on your financial statements is to enable you to present the audited financial statements to NoLoan Bank and Trust. We are not aware of any other persons, entities, or limited groups of persons or entities for whose use or benefit this report is intended or contemplated. In the event that, during the term of this engagement, you decide to provide a copy of the audited financial statements to a particular person or entity in connection with a contemplated transaction, you have agreed to notify us in writing prior to the issuance of the report of the identity of such person or entity and the size and nature of the contemplated transaction.

Indemnification:

If we incur legal fees as a result of our reliance on any *false representation made by you*, you agree to reimburse us for all of our legal fees and related costs of defense.

Note: There are several cases cited by malpractice insurance carriers where a CPA firm was sued by a former client who went bankrupt and sued the CPA firm for the audit failure. This action occurred even though management lied to the firm about certain issues. By including the previous indemnification language in the engagement letter, the firm was able to favorably settle the case and received reimbursement of its legal fees for its defense.

Ownership of Records:

Our working papers of our engagement remain the property of James J. Fox & Company and constitute confidential information. Except as discussed below, any requests for access to our working papers will be discussed with you before making them available to requesting parties.

a) Our firm, as well as other accounting firms, participate in a peer review program covering our audit and accounting practices. This program requires that once every three years we subject our system of quality control to an examination by another accounting firm. As part of this process, the other firm will review a sample of our work. It is possible that the work we perform for you may be selected for review. If it is, the other firm is bound by professional standards to keep all information confidential.

b) We may be required to make certain workpapers available to Joe Regulator pursuant to authority given to it by law or regulation. If requested, access to such workpapers will be provided under the supervision of our firm personnel. Further, upon request, we may provide copies of selected workpapers to Joe Regulator and such copies may be distributed by Joe Regulator to other third parties including government agencies.

Mediation:

In the event of a dispute over our engagement, we mutually agree that any dispute that may arise in connection with our engagement will be submitted to mediation by selecting a third party to help us reach an agreement. We acknowledge that the results of this mediation will not be binding upon either of us. The costs of the mediation will be shared equally by both of us.

What about an arbitration clause?

Generally, arbitration clauses are dangerous with respect to a professional engagement. Arbitration is legally binding and the process can restrict the accountant from proving his or her case. Arbitrators are known for “splitting the difference” and there are limitations on the extent of discovery that can be presented in the hearing. In a malpractice case, an accountant that has excellent workpapers may be precluded from presenting those papers as evidence.

Most insurance carriers state that an arbitration clause should be avoided and can be included only with respect to fee disputes, and not malpractice cases.

Recommendation: Watch Out For Bad Clients

An auditor should be watchful of clients and related engagements that may have a high risk of lawsuit. In particular, certain clients have attributes that, in the event of loss, could lead to litigation.

In particular, there has been recent discussion of the importance of assessing clients. An in-depth discussion of this issue was presented in an article published in *The Practicing CPA*, entitled, *Do You See Trouble When It Walks in the Door?* (Mary C. Eklund, Esq.).

In her article, Ms. Eklund makes reference to the idea of "bad clients" and that CPAs continue to expose themselves to litigation when they fail to consider whether a particular client represents a litigation risk. Many times, the CPA recognizes that there could be a risk, yet takes no action because "it couldn't happen to us."

Ms. Eklund identifies several early hints of trouble that the CPA should be aware of such as:

1. Symptoms of a Problem Client:

a. <u>High business risk</u>:

- In a start-up mode
- Poor record keeping
- Operates in litigious or declining industry
- Has a history of litigation
- Has poor internal control
- High employee turnover, such as the accounting department
- Director resignation
- Slow payment to suppliers and service providers
- Has poor credit or inadequate working capital
- Large or unusual year-end transactions
- Unusual sources of loans or high rates on loans
- Material transactions not recorded in the usual manner
- Suspicious confirmation responses
- Owner acts dishonestly

b. Deterioration in the client's relationship with the firm:

A client who:

- Does not deliver information on a timely basis
- Fails to pay the firm on time
- Has unrealistic schedules, deadlines and demands by the client
- Fails to return the firm's telephone calls
- Is unreasonable or consistently ignores the accountant's advice, is disreputable and a bully
- Demands an unusually low fee or unrealistically fast service
- Refuses to sign engagement or representation letters
- Gives evasive answers or makes it difficult for auditors/accountants to get information or documents
- Has significant weaknesses in accounting and administration controls
- Whose personality and attitude changes
- Has personal financial pressures
- Has a history of changing accounting firms

- Who creates emotional turmoil

c. Change in client's business:

- Company plans to go public
- Business is for sale
- Client ownership and management transition is in process that may expose the firm's work to heightened scrutiny
- There is a change in the client's type of business that places the firm into unknown, unfamiliar areas outside of its expertise.

d. Conflict of interest issue emerges: Intra-family disputes, including potential divorce or sibling fighting may place the auditor in the middle of a battle that could lead to ultimately being sued by all sides involved.

e. Management's disregard for internal controls and record keeping: Management sets the tone for the organization. If management has a low regard for internal controls and recordkeeping, that attitude will permeate throughout the organization.

f. Management refuses to sign engagement or representation letters: Management's unwillingness to sign an engagement letter is a red flag that management cannot be trusted. Management's refusal to sign a representation letter is a scope limitation.

Observation: There are two important changes that can significantly expose the auditor to risk: a sale of the business and a change in management. If a sale of business is anticipated, the client may attempt to inflate earnings and equity to increase the sales price. Because the sales price is a multiple of earnings (e.g., multiple times EBITDA), the impact of a small increase in net income may be significant. For example, if a client intentionally inflates income by $100,000, it could impact the sales price by $500,000, based on a five-times EBITDA multiple. In addition, the purchaser may have a third-party claim against the auditor because the purchaser will be a known third party to the auditor, most likely relying on his or her audit report and related financial statements to formulate the purchase price.

The second situation in which an auditor is most vulnerable to being sued is where a client hires new management. When a new manager arrives, he or she may uncover a fraud, defalcation, or error relating to the previous manager. The manager may hire his or her own auditor, who further scrutinizes the work of the predecessor auditor. This scenario could result in a claim against the auditor.

If the auditor sees some of the symptoms of a bad client, he or she should reconsider whether the risk is too significant to continue with the engagement. Ways to evaluate whether to continue with the engagement include the following:

a. *Evaluate the client's real needs and demands:* Consider the services needed in addition to those requested. Ask the question: Can we do what is needed for the amount being paid?

b. *Evaluate the firm's (individual's) ability to handle the client's needs and demands:*

- Does the firm have the expertise and staffing necessary to do the job?

c. *Interview the predecessor accountant, if this is a new client:*
Ask the following questions:

- Has the client ever lied to you?
- Has the client ever unreasonably delayed payment or refused to pay you?
- Did the client ever refuse to sign an engagement or representation letter?
- Has the client ever threatened to sue you?
- Have you ever had a disagreement with the client on accounting principles or tax matters?

d. *Perform an industry check*: Ask the prospective client for a list of customers and suppliers and permission to talk with them.

- Does the client pay his/her bills on time, have respect, and maintain good relationships with peers?
- Find out whether the industry is subject to frequent or sudden business failures.

The AICPA's Practice Aid *Acceptance and Continuance of Audit Clients* highlights matters that auditors may wish to consider in connection with establishing policies and procedures for client acceptance and continuance.

Problem clients have proven to be *one of the principal factors giving rise to liability claims against auditors***.** Auditors should consider establishing a general firm philosophy specific to client acceptance.

Example: Firm only accepts clients who are engaged in legitimate pursuits and should not present undue business risks to the firm or adversely affect the firm's reputation and should not ____ [fill in].

Recommended procedures:

- Obtain an understanding of the client's business.

- Inquire as to the client's reputation and that of high-ranking employees and owners.

- Consider management's response to observations about or suggestions for improvements in internal controls made by the predecessor auditor.

- Consider the composition and autonomy of the board of directors.
- Communicate with the predecessor auditor and inquire as to the reasons for the change in auditor and to the integrity of management.
- Consider the firm's independence with respect to the client.
- Consider whether the firm is qualified to handle the audit.

Auditors should devise a formal client acceptance/retention policy based on a client's undesirable qualities:

a) Management lacks integrity

b) Weak financial condition

c) Unwillingness to pay professional service fees

d) Management that chronically enters into material high-risk transactions

e) Disregard for internal controls and record keeping

f) Management refuses to sign engagement or representation letters.

Observation: In the post-Andersen era, with the introduction of the Sarbanes-Oxley Act, many national firms have purged their client list of clients in high risk industries or that, individually, represent an unacceptable risk to the firm. Other firms are following the same tact in that they are simply not willing to take the risk of being sued when compared to the amount of the audit fee derived from the engagement.

How to get rid of bad clients!

Eliminating a bad client from the firm's client list can create a greater risk than keeping the client, if the action is not handled properly. In many instances, notifying the client that the firm will no longer service his or her account can cause resentment which, in turn, can translate to blame. Also, there is the issue of how to handle outstanding fees. Should the firm demand payment or forgive the balance? There are also successor accountant/auditor matters where the firm must be careful not to provide information to the successor without obtaining permission from the client. Let's not forget that approximately 85 percent of all lawsuits against accountants are initiated by the client, not third parties.

Evaluating new clients

In connection with a prospective client, the firm should set up a new client acceptance policy that includes evaluating the prospect in more depth before being accepted as a new client.

Recommendation: Protect the Privity Defense Against Third Parties

Lawsuits initiated by clients against the auditor may take a different form than those from third parties, such as banks, investors, etc. Most frequently, the client sues for breach of contract using the notion that the auditor failed to render the agreed-upon services in the manner contracted in the engagement letter. Generally, an auditor may be sued under any one of the following *five causes of action:*

1. **Breach of contract:** The auditor failed to perform the agreed-upon services in the manner contracted in the engagement letter (or verbally, if no engagement letter was signed).

2. **Negligence:** The auditor failed to meet professional accounting and auditing standards.

3. **Negligent misrepresentation:** The auditor provided erroneous information to the client through failure to exercise due care.

4. **Fraud:** The auditor knowingly or recklessly made a material false statement of fact or omitted a material fact.

5. **Breach of fiduciary duty:** The auditor failed to uphold the responsibility associated with professionalism and accountability. Examples include unauthorized disclosure of confidential client information.

Any one or all of the above five causes of action can be brought by a client against an auditor. However, what about damages claimed by a third party such as a bank, investor or bonding company? Since the third party usually is not a party to the contract (e.g., engagement letter), what causes of action can it bring?

For years, the answer was found in the so-called ***privity standard,*** developed after an old 1931 court case, *Ultramares Corp. v. Touche, Niven & Co.* (New York, 1931).

The privity (contract) standard states:

> ***"Accountants' liability is limited to those third parties with whom the accountant has a contractual relationship."***

Under a strict interpretation of this privity standard, the accountant is exempt from responsibility to a third party unless the accountant has a contract with that third party. And, usually, the third party is not a party to the contract (e.g., engagement letter), giving the accountant a shield against third party lawsuits.

Unfortunately for accountants, since the inception of the privity standard in 1931, case law and most state statutes have watered down the privity standard to the extent that it applies only in a few states. The result is that, depending on the state of jurisdiction, responsibility to third parties can be categorized into *four different levels* as follows:

1. Privity (discussed above)
2. Near-privity
3. Restatement approach
4. Foreseeability approach

Near-privity: Under the near-privity (near-contract) standard, a third-party that does not have a contractual relationship with the accountant can still bring suit against an accountant for negligence if ***all three*** of the following conditions apply:

1. The accountant is aware that his or her financial report is to be used for a particular purpose.

2. A specific, ***known third party***, intends to rely on the financial report, and

3. The accountant's conduct clearly demonstrates that the accountant is aware the third party will rely on the financial report.

Note: The near-privity standard is based on the case *of Credit Alliance Corporation v. Arthur Andersen & Co.* (1985) in which an auditor was sued by a lender in connection with a client that filed bankruptcy. Under the near-privity standard, the accountant must know who the third party is and the fact that the specific third party will rely on the accountant's report. The task of documenting that an accountant was aware of third party's reliance on the report has not been clearly decided by the courts since the Credit Alliance case. For example, is a telephone call initiated by a third party to an accountant adequate to confirm that the accountant knew the third party and that the party would rely on his or her report? It is not clear. What is clear is that knowing that some *unidentified third party* will receive the report is usually not enough. The identity of the third party must be known for the near-privity defense to be challenged by a third party.

Restatement approach: In those states that follow the restatement approach, accountants are responsible to third parties who fall into *either one* of two categories:

1. Third parties the accountant *expressly knows* will be provided with the financial report, and

2. Third parties who are members of a *limited class of persons* to whom the accountant knows the financial report will be given.

   Note: The restatement approach requires that the accountant know the class of third party (e.g., bankers, insurance companies, etc.), but not necessarily the name of the party. This is different from the requirement of the near-privity defense where the name of the third party must be identified.

   Example 1: Fred, an accountant audits a client's financial statements and issues an unqualified report. Fred gives the client several copies of the financial statements without knowing specifically to whom the statements will be provided. The client gives a copy of the statements to a vendor who grants credit to the client. Subsequently, the client's business fails and the vendor sues Fred for negligence. The state of jurisdiction follows the restatement approach for responsibility to third parties.

Conclusion: Fred is not liable to the vendor because he did not have notice that the financial statements would be given to the creditor or to a class of third parties (e.g. vendors).

Example 2: Same facts as Example 1, except that during the audit, the client informs Fred that the statements will be issued to the vendor, names the vendor, and states that the vendor will be using the statements to grant credit to the client.

Conclusion: Under the restatement approach, Fred would be responsible to the vendor because he expressly knew the financial statements would be given to the vendor.

Example 3: Same facts as Example 2, except that during the audit, the client informs Fred that the statements will be issued to one or more vendors without disclosing names.

Conclusion: Under the restatement approach, Fred would be responsible to any vendor to whom the statements were given because Fred was aware the statements would be given to a *particular class of third parties (vendors*).

Note: In the above series of examples, if the state of jurisdiction followed the near-privity standard, Fred would have been liable to the third party in Example 2 only, where Fred was informed that a known, third party would rely on the report for a particular purpose, to issue credit.

Foreseeability approach: The accountant is liable to any **"***reasonably foreseeable***"** third-party recipient of the accountant's financial report provided the third party relies on the report for its proper business purpose. Further, the accountant is not required to know the specific third party or how the report will be used.

Example: An insurance company obtains a copy of a client's financial statements used to issue an employee fraud policy. Subsequently, employee fraud is found and a claim is made against the policy. The insurance company sues the auditor, claiming that the auditor did not disclose certain known information that would have resulted in rejection of the insurance application. The state of jurisdiction follows the foreseeability approach for third-party liability.

Conclusion: Assuming there is negligence, the auditor is liable to the insurance company under the foreseeability approach. It was **"***reasonably foreseeable***"** for the insurance company to be the recipient of the accountant's financial report. This is the case even though the auditor did not know about the insurance company or the purpose for which the insurance company would use the report.

Observation: The foreseeability approach is a very dangerous standard for accountants. The good news is that, presently, only two states, Wisconsin and Mississippi, follow the foreseeability approach to third-party liability.

The following chart, published by the AICPA, illustrates the third-party liability laws, by state. The categorization of each state is always changing based on that state's recent laws and court decisions.

Summary of Third-Party Liability By State			
Privity States		**Near Privity States**	
Pennsylvania		Arkansas	Montana
Virginia		Idaho	Nebraska
		Illinois	New Jersey
		Kansas	New York
		Louisiana	Utah
		Michigan	Wyoming
Restatement States		**Foreseeability States**	
Alabama	Minnesota	Mississippi	
Alaska	Missouri	Wisconsin	
Arizona	New Hampshire		
California	North Carolina	**States Not Categorized**	
Colorado	Ohio	Delaware	North Dakota
Colorado	South Carolina	Indiana	Oklahoma
Connecticut	Tennessee	Kentucky	Oregon
Florida	Texas	Maine	Rhode Island
Georgia	Washington	Maryland	South Dakota
Hawaii	West Virginia	Nevada	Vermont
Iowa		New Mexico	
Massachusetts			

Source: AICPA Compilation and Review Alert, as modified by the author.

Recommendation: Make Sure You Have a Workpaper Retention Policy:

Auditors should formulate a ***workpaper retention policy*** that includes the following:

1. The document retention period should be sufficiently long enough to:

   - Negate an inference that it was designed to destroy information that could injure the firm, and
   - Satisfy the auditor's reasonable needs to obtain information regarding the entity's prior financial activities.

2. The retention period should be rational in the sense that a longer retention period should be maintained for documents which are likely to be called upon at a later date.

3. The retention policy should be scrupulously adhered to so as to avoid an inference that documents were destroyed because they were the subject of litigation.

Note: SAS No. 122, AU-C 230, *Audit Documentation* (formerly SAS No. 103),[31] requires an auditor to retain audit documentation for a sufficient period of time with a *minimum workpaper retention period of five years* from the report release date, or longer if required by statutes, regulations, or the firm's internal quality control policies.

Observation: Historically, in lawsuits against accounting firms, a key factor supporting the firm's discarding of its workpapers has been whether the firm did so during a timeframe that was consistent with the firm's retention policy.

During the Enron scandal, the auditor, Arthur Andersen, was accused of shredding working papers. The firm was indicted because the shredding occurred after the firm received a subpoena for its workpapers. If, instead, the firm had not received the subpoena, presumably, the firm would have had the right to shred its workpapers provided that shredding was consistent with the firm's workpaper retention policy.

The moral of the story is that if a firm has a retention policy, it is imperative that it follow it consistently so that a third party cannot accuse the firm of discarding workpapers as a means to remove damaging evidence in a lawsuit.

Sarbanes-Oxley requires auditors of SEC companies to maintain a seven-year workpaper retention policy. Since the adoption of Sarbanes, several state licensing boards have adopted portions of Sarbanes, one of which is the requirement of a seven-year retention policy for all auditors, including those of non-public entities.

Recommendation: Tighten Up Workpapers

Perhaps the most important litigation-proofing a firm can implement is to tighten up its workpapers**.** In litigation, a firm's workpapers are its evidence that it performed the engagement with due care in accordance with GAAP, GAAS or the SSARSs. In front of a jury, a talented plaintiff's attorney can translate a series of minor workpaper flaws into a negligently performed engagement. The following analysis identifies certain chronic workpaper deficiencies that have been recurring in litigation.

1. Complete the audit program:

    a. Never leave a procedure incomplete (blank) in the program.

    b. Do not place *"not applicable"* next to a procedure that could be performed, but the accountant/auditor elects not to do it.

    c. If the procedure is not needed, it should be eliminated from the program altogether.

Note: All major publishers offer the audit program in electronic format. This allows the firm to customize the program and remove any standard procedures that are not going to be performed

[31] Effective December 31, 2012, AU-C 230, *Audit Documentation* replaces SAS No. 103.

during the engagement. From a liability standpoint, it is better for an audit program to be brief and for all procedures in the program to be completed, than for a larger, canned program to be used that has a series of incomplete procedures.

2. Remove all *"to do"* lists or other comments or scribbles from the workpapers that suggest that the engagement was not completed.

3. Never place jokes in the workpapers or comments about the client.

4. Make sure there is a partner review and sign off on workpapers.

5. Perform analytical procedures:

   - Analytical procedures that demonstrate no unusual fluctuations are a strong defense in a fraud claim.

   - Comparison of data from year to year is the best means to detect going concern and cash flow problems.

6. Label preliminary financial statements with *"draft" or "draft-for internal use only."*

7. Document, document, document:

   - Show support for positions taken such as AICPA, Hotlines, etc.
   - Never speculate, only state facts.
   - Conclude on procedures performed.
   - Document all communications with client noting the date and what was discussed.

   Note: An auditor must document the work he or she does in conducting his or her audit. Specifically, the auditor must obtain abstracts or *copies of significant contracts or agreements* that were examined to evaluate the accounting for significant transactions.

   Example: Joe Auditor is auditing X's accounts receivable. X has a contract with one large customer that allows for the customer to delay payment (dated terms) for a period of time. Joe inspects the contract in determining whether accounts receivable is collectible.

   Conclusion: Joe should document the contract inspected including retaining a copy of the contract in his working papers.

   Audit documentation should include *identification of the items tested*.

   - When *a random sample is selected*, the documentation should include *identifying characteristics*, such as specific invoice numbers of the items selected, and *the listing*.

   - When a *scope of items is selected* (e.g., all items over a certain amount) the documentation needs to describe *the scope* and *the listing*.

- When a *systematic sample is selected* from a population of documents, the documentation need only provide an *identification of the source documents, the starting point, and the sampling interval*.

  Example 2: Mary Auditor is auditing Company X and selecting customer receivables for confirmation. Mary uses random sampling by selecting 100 random customers from the accounts receivable aging.

  Conclusion: Because Mary is using random sampling, in her working papers, she should document *specific customers* and *amounts selected* for the confirmation, and the listing from which the customers were selected.

  Acceptable documentation would consist of:

  "Randomly selected the following 100 customers from the client's accounts receivable aging as of December 31, 20XX"

Customer	***Customer #***	***Balance***
Smith	*56346*	*$xx*
Johns	*34356*	*xx*
Johnson	*67894*	*xx*
Etc……..		
Total selected for confirmation		*$xx*

Unacceptable documentation:

"Randomly selected 100 customers off the client's aging with a total balance of $xxx."

The previous example is unacceptable because the sample does not provide a means by which another party could reconstruct the sample (e.g., selected every fifth customer off the aging, etc.).

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. With regard to hiring and supervising staff, accountants should:
   a. Check employee references
   b. Emphasize quantity over quality
   c. Allow employees to moonlighting
   d. Use per-diem employees

2. Which provision, that might assist the auditor in litigation, is required to be included in the engagement letter:
   a. Arbitration clause
   b. Limitations for unknown third parties on use or reproduction of the audit report
   c. Ownership of workpapers
   d. Responsibilities for fraud

3. Which of the following would <u>not</u> generally expose an auditor to a risk from having a problem client:
   a. A client's planned purchase of long-term assets
   b. A change in the client's management
   c. A deterioration in the client's relationship with the firm
   d. The client's sale of a subsidiary

4. Which of the following liability standards states that only third parties with contractual relationships with the accountant may bring suit against an accountant for negligence:
   a. The foreseeability approach
   b. The near-privity standard
   c. The privity standard
   d. The restatement approach

5. Under what level of responsibility to third parties can both the third party and the use of the financial report be unknown to the accountant and that he or she is still responsible to the unknown party:
   a. The foreseeability approach
   b. The near-privity standard
   c. The privity standard
   d. The restatement approach

SUGGESTED SOLUTIONS

1. With regard to hiring and supervising staff, accountants should:
   a. Correct. A common pitfall that continues to expose accountants to loss in litigation is failure to properly hire and supervise staff. To avoid exposure to loss in litigation, accountants in hiring and supervising positions should check employee references.
   b. Incorrect. To avoid exposure to loss in litigation, accountants in hiring and supervising positions should emphasize quality over quantity. A deterioration of quality in exchange for speed exposes the firm to the risk of errors.
   c. Incorrect. Accountants in hiring and supervising positions should prohibit employee moonlighting. Employees who moonlight may have poorer job performance during the day and usually do not carry personal liability insurance.
   d. Incorrect. Accountants should be aware of the risks of using per-diem employees. Not checking to ensure that per-diem employees have adequate CPE in the area of the engagement; not properly overseeing their work; not giving them the same degree of supervision as other staff; and accepting their bad workpaper habits, are some common oversights.

2. Which provision, that might assist the auditor in litigation, is required to be included in the engagement letter:
   a. Incorrect. An arbitration clause is not required to be in an engagement letter under auditing standards. As a matter of good practice, a mediation clause is recommended, but not an arbitration clause.
   b. Incorrect. A provision stating limitations on use or reproduction of the audit report for unknown third parties is recommended, but not required.
   c. Incorrect. A provision stating the ownership of workpapers is recommended, but not required.
   d. Correct. A provision required by AU-C 240 (formerly SAS No. 99), which might assist the auditor in litigation, is to state the responsibilities for fraud in the engagement letter.

3. Which of the following would <u>not</u> generally expose an auditor to a risk from having a problem client:
   a. Correct. The fact that the client has a planned purchase of long-term assets does not, in and of itself, expose an auditor to risk of having a problem client. Purchasing long-term assets is a function performed in the normal course of business and should not increase the auditor's risk.
   b. Incorrect. Hiring new management generally does expose the auditor to risk from having a problem client. An auditor is most vulnerable to being sued when a client hires new management. When a new manager arrives, he or she may uncover a fraud, defalcation, or error relating to the previous manager and may hire his or her own auditor. The result could be a claim against the predecessor auditor.
   c. Incorrect. A deterioration in the client's relationship with the firm is a symptom of a problem client. In particular a client who does not deliver information timely, fails to pay the firm on time, and has personal financial pressures, is one that should be categorized as high risk.

d. Incorrect. The sale of a business can significantly expose the auditor to risk because the company may attempt to inflate earnings and equity to increase the sales price.

4. Which of the following liability standards states that only third parties with contractual relationships with the accountant may bring suit against an accountant for negligence:
   a. Incorrect. The foreseeability approach does not state that only third parties with contractual relationships with the accountant may bring suit. Instead, this approach states that the accountant is liable to any "reasonably foreseeable" third-party recipient of the accountant's financial report provided the third party relies on the report for its proper business purpose.
   b. Incorrect. The near-privity standard states that three conditions must be met for a third party with no contractual relationship with the accountant to bring suit against an accountant for negligence. It does not provide that only third parties with contractual relationships may bring suit.
   c. Correct. The privity (contract) standard, in its purest form, allows for only third parties with contractual relationships with the accountant to bring suit against an accountant for negligence.
   d. Incorrect. The restatement approach states that accountants are responsible to third parties who the accountant expressly knows will be provided with the financial report and third parties who are members of a limited class of persons to whom the accountant knows the financial report will be given. This approach does not restrict the ability to sue the accountant to those third parties with contractual relationships.

5. Under what level of responsibility to third parties can both the third party and the use of the financial report be unknown to the accountant, and, yet he or she is still responsible to the unknown party:
   a. Correct. Under the foreseeability approach, both the third party and the use of the financial report can be unknown to the accountant.
   b. Incorrect. Under the near-privity standard, the accountant must be aware that the financial report is to be used for a particular purpose and must know who the third party is and the fact that the specific third party will rely on the accountant's report.
   c. Incorrect. Under the privity standard, to be held responsible, the accountant must have a contractual relationship with the third party.
   d. Incorrect. Under the restatement approach, accountants are required to know the class of third party, but not necessarily the name of the party.

XIV. Efficient Engagements- Reduce Time, Make More Money Without Increasing Risk

A. Staffing Problems

The AICPA's Private Companies Practice Section (PCPS) published the results of its annual poll of the Top Ten CPA Firm Issues, which is listed below based on firm size of 6 to 10 professionals.

Top Ten CPA Firm Issues

1. Client retention
2. Retaining qualified staff at all levels
3. Tax complexity and changes
4. The effect of new regulations and standards on small firms
5. Marketing/practice growth
6. Finding qualified staff
7. Client collections
8. Keeping up with standards
9. Keeping up with technology
10. Working/life balance initiatives

Source: AICPA

Items 2 and 6, retaining and finding staff, have been at the top of the list for the past five years and staffing issues continue to be the number one challenge facing the profession. The staffing issue, coupled with the pressure to keep up with regulations and standards, make the engagement efficiency a vital element of any CPA firm's quality control practice.

Another observation made by CPA firms is that the quality of staff is not as extensive as prior generations thereby making it more difficult to drive performance. Consider some of the common comments about staff:

Today’s accounting graduate lacks:

- Basic writing and math skills
- Work ethic needed for many firms to drive through the cyclical seasons of the typical CPA firm.

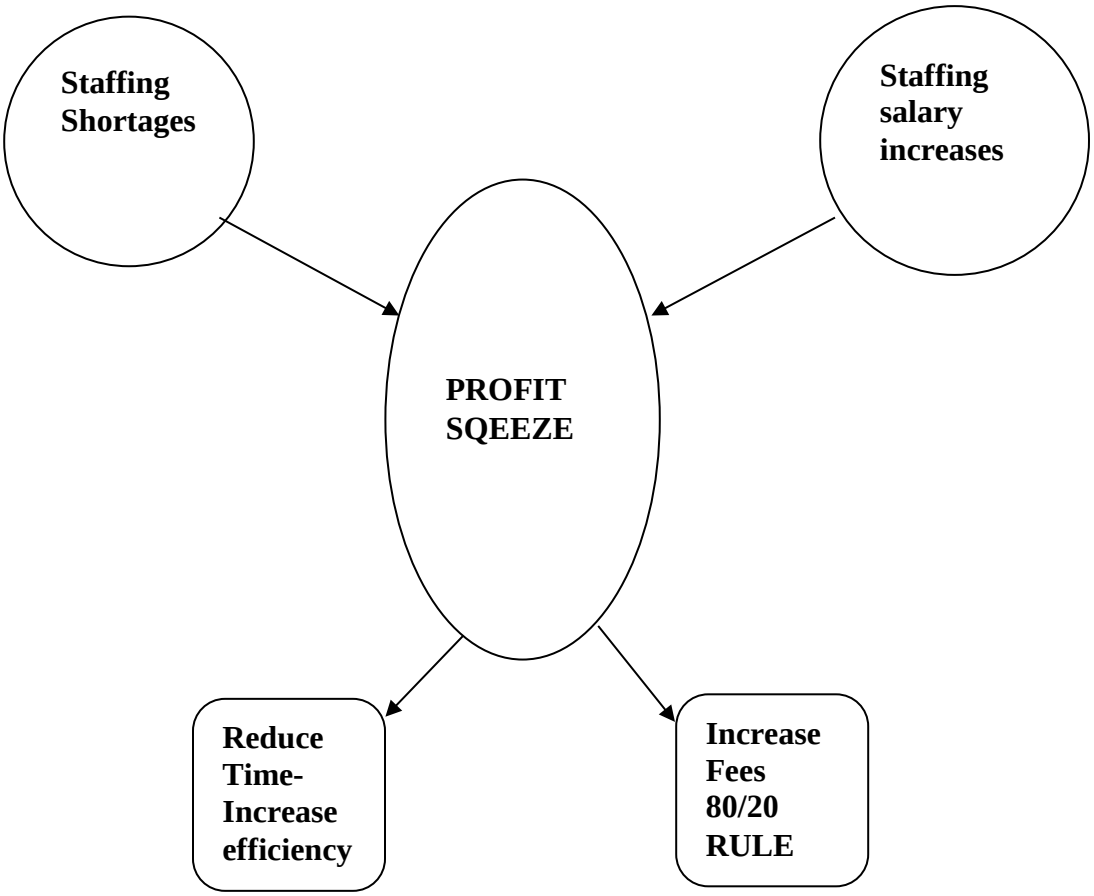
What this means is that many firms are unable to generate high production out of staff members thereby putting pressure on the firm to ensure that engagements are performed efficiently.

Efficiency Auditing Takes the Pressure Off Staffing Issues

In general, firms are over auditing, over reviewing and over compiling, resulting in wasted time that could be used to drive other business or, the ability to perform the same volume of work with

fewer staff. With the expansion of regulations and standards, firms may find their profit margins being squeezed if they do not make their engagements more efficient.

Dealing with the Challenges of Profit Squeeze



B. Efficiency Auditing

The PCPS Section of the AICPA published a handbook entitled *Smarter Audits*, which provides CPAs with ideas on ways to make audits more efficient. Although the majority of the following suggestions and comments have been developed by the author, several important ideas were extracted from the PCPS document.

The following are suggestions on how a firm can reduce time and increase audit efficiency:

- Manage and train the client and its staff

- Weed out unprofitable clients and increase fees
- Retain and effectively use staff
- Spend more time planning the engagement
- Recommend that the client convert to income-tax-basis accrual financial statements, where appropriate
- Recommend that the client switch to a review from an audit, and
- Look at specific audit areas for time savings.

1. Managing and training the client

a. Ask the client to perform more PBC (prepared by client) schedules to eliminate wasted audit time reconstructing transactions.

- The client should have a clear due date for the PBCs and a format example
- Do not start the audit until all PBCs are completed.

Note: Some firms charge a separate billing for the accounting work so that the client can see the impact of having the accountant perform many wasted tasks that could be performed by the client. Some firms are willing to discount the bill if the client prepares PBCs and reduces the engagement time.

2. Weed out unprofitable clients and increase fees

Because of staffing shortages, it may make sense to reduce the client base and operate on a more solid, profitable one.

Statistics show that there is tremendous time savings from performing engagements on repeat clients where work papers have already been set up and the staff is already familiar with the industry and client. However, unprofitable clients, particularly those that have year ends during busy times of the year, may not be worth keeping.

a. <u>Get rid of unprofitable clients:</u>

1) The 80-20 rule applies: 80% of a firm's business comes from 20% of its clients.
2) Clients that are high-risk, slow paying, high-maintenance, and low-profitability may not be worth keeping.
3) It may be too time consuming to retain one client who is in an industry within which no other clients exist.
4) The first clients to go should be those who have year ends at busy times of the year such as calendar year ends. Firms can generally replace unprofitable year end business with other more profitable clients.

b. Increase fees: One way to weed out clients is to increase fees, particularly within areas of recognized expertise. Clearly, the timing of the economy may be a factor in deciding when you increase fees and weed out clients.

3. Retain and effectively use staff

The most efficient audits are performed by staff who is already familiar with the client from performing the engagement in prior years.

a. Firms should retain staff as a means of enhancing client relations and providing significant audit efficiencies.

b. Clients like to work with the same staff from year to year.

4. Spend more time planning the engagement

Auditors are required to plan the audit. However, in this case, the term "planning" refers to the process of making sure the pieces work together including staffing, timing, and extent of work to be done.

a. Successful firms plan the engagement in the following areas:

- Plan the audit based on risk and materiality
- Allocate hours to spend on each area
- Attempt to eliminate duplicate tests, where possible
- Develop PBC lists and due dates
- Prepare the engagement letter
- Prepare a budget

b. Specific planning opportunities:

- Focus audit on high risk areas
- Complete your work paper review and exit interview prior to leaving the client's office
- Move certain audit work to interim such as receivable confirmations and inventory observations.

5. Recommend that the client convert to tax-basis accrual financial statements

Most closely held businesses focus on tax reduction planning and less on issuing GAAP financial statements. Consequently, for them, tax basis, accrual financial statements may be more meaningful.

What is just as important is the significant savings to you, as an auditor. Because tax-basis financial statements are not GAAP, the rules for GAAP do not apply. Instead, if tax basis financial statements are prepared, the authority for when to record income and expense is determined by the

Internal Revenue Code, not GAAP. The most common non-GAAP basis to use is tax basis accrual financial statements since usually the results of operations do not significantly deviate from operations reported under GAAP.

Note: Under new auditing standards, the term "income tax basis" is replaced with the term "tax-basis" and the term "other comprehensive basis of accounting (OCBOA) is replaced with the term "special purpose framework" to reflect non-GAAP frameworks.

Traditional GAAP items you can forget about when using income tax basis statements include:

- Deferred income taxes
- Accrued vacation pay
- Investments at market value
- Impairment of long-lived assets
- Consolidation of variable interest entities (VIEs)
- Allowance for bad debts
- Different depreciation methods
- UNICAP- section 263A adjustment
- Goodwill amortization

The time savings can be significant!

6. Recommend that your client switch from an audit to a review

In limited cases, a review may be more appropriate for a client than an audit, and more profitable to the CPA firm. Although the billing amount may be lower, the profit on a review can be much greater than an audit. It is better that an auditor, rather than a competitor, promotes savings to his or her client.

7. Look at specific audit areas for time savings

The author suggests that firms consider some of the following areas for significant time savings:

a. Reassess the materiality threshold established for the audit:

- Many firms set materiality too low and do too much work based on the assessment.
- The rule of thumb threshold is 5-10% of net income or 5% of total assets.

b. Streamline the audit program:

- Never have any procedure in the audit program that will not be performed.
- Do not used "canned" programs which include too many procedures.

c. Replace tests of account balances with analytical procedures in low risk audit areas:

Examples of areas in which analytical procedures can replace typical tests of account balances include any variable operating expense and those balance sheet accounts that have low inherent risk (e.g., prepaid and accrued items) such as:

- Interest expense as % of average debt
- Payroll tax expense as % of gross payroll
- Repairs and maintenance as % of fixed assets
- Sales returns and allowances as % of sales
- Other operating expenses from year to year
- Recurring prepaid expenses and accruals

Observation: Auditors should seriously consider increasing the use of analytical procedures as effective substantive tests in lieu of tests of account balances. By doing so, audit time can be significantly decreased without sacrificing the quality of the audit. More importantly, analytical procedures are extremely effective in uncovering material misstatements.

d. Increase audit work in high-risk areas such as inventories and receivables.

e. Eliminate wasted audit procedures: The following chart presents some of the areas in which audits waste time.

Audit area	**Recommended procedure to save time**
Cash	• Eliminate request for cut-off statements. For the first month after the client's year end, use the client's bank statement when received and instruct client to deliver the statement to the auditor unopened, or inspect the bank statement electronically through the client's on-line banking. • Don't confirm bank accounts. Obtain client's bank statement unopened for the month following the year end and trace the balance into the bank statement or review the client's bank account on line in the presence of the client.
Accounts receivable	• Confirm receivables at interim, within one or two months of year end. • Stratify the confirmation population: Send positive confirmations to the largest customers, negative confirmations to the next largest customers and eliminate confirmations to the lowest 20% of the balances. • Eliminate confirmations of receivables altogether where, based on history, results have not been successful and perform alternative procedures.
Inventories	• Perform physical observation at interim and roll forward the balance to year end. • Test a percentage of the valuation using the largest items within the population and perform analytical procedures such as gross profit test, number of days, and inventory turnover. • Perform lower of cost of market on the entire inventory and not individual inventory items
Accounts payable	• Generally, do not confirm trade payables. Confirmation usually does not test for the highest risk which is having unrecorded liabilities.

	• Search for unrecorded liabilities by examining subsequent cash disbursements and invoices
Contingencies and lawyers' letters.	• Do not send lawyers letters for unasserted claims. • Lawyers' letters should only be sent to confirm the facts of a contingency that is asserted by management.
Prepaid expenses and accruals	• Test prepaid expenses and accruals analytically instead of testing account balances. • Do not test details of account balances unless the analytical procedures result in a significant variance from year to year or from the current year in comparison with expected amounts.
Expenses	• Test analytically and avoid an analysis of the account balance unless analytical procedures indicate a significant fluctuation. • Initially test repairs and maintenance analytically from year to year and, if possible, avoid examining individual repairs and maintenance items.

Are receivable confirmations required?

SAS No. 122, AU-C Section 505, *External Confirmation* (formerly SAS No. 67)[32] was issued in response to the concerns that the profession was over utilizing confirmations as an effective substantive test. Almost a decade later, it appears that CPA firms continue to misuse and overuse confirmations.

Understanding AU-C 505 (formerly SAS No. 67) can be an effective tool to reduce audit time

AU-C 505 states that there is a *presumptive mandatory requirement* that an auditor will request confirmations for receivables. If he or she does not request confirmations, he or she must document how this presumption was overcome.

AU-C 505 states that the auditor should use external confirmation procedures for accounts receivable, except when *one or more* of the following exists:

- The overall account balance is immaterial
- External confirmation procedures for accounts receivable would be *ineffective*, or
- The auditor's assessed level of risk of material misstatement at the relevant assertion level is *low*, and other planned substantive procedures address the assessed risk.

Example: Based on history, the auditor can expect that response rates will be low.

AU-C 505 stipulates *that negative confirmations may not be used* unless:

[32] Effective for years ending on December 31, 2012 and later, AU-C 505, *External Confirmations* replaces SAS No. 67.

- Control risk is set at below the maximum level
- There are a large number of small account balances
- The auditor expects a very low exception rate, and
- The auditor is not aware of any conditions that would cause recipients of the negative confirmations not to reply.

Therefore, positive confirmations should be used instead of negative ones for the majority of the receivable population tested.

With respect to accounts receivable, there is the presumption that the auditor will request accounts receivable confirmations unless the use of confirmations would be an ineffective audit procedure. In those cases, accounts receivable confirmations can be replaced with alternative substantive tests such as:

1. Sales cutoff
2. Examination of certain invoices included in the balances of significant receivables
3. Analytical procedures such as number of days sales and receivable turnover
4. Realization of receivable balances

Avoiding the time trap of prepaid and accrued expenses

Do you want to reduce your audit time but not increase audit risk?

One easy way to do so is to make sure you do not get locked into the time trap of spending too much time performing detailed analyses of prepaid expenses and accruals. Instead, the auditor should initially test these accounts analytically from year to year. Only if there is a significant fluctuation in the prepaid or accrued expense balance from year to year (adjusted for any expected change), should an auditor spend time with detailed analyses of the prepaid or accrued account.

Example: Joe Auditor is auditing Company X. X has a prepaid insurance asset on the balance sheet as follows:

	20X2	20X1
Prepaid insurance	$20,000	$23,000
Insurance expense	40,000	38,000

Joe's expectation is that 20X2 insurance expense and prepaid insurance should be similar to 20X1 because there is no indication that there has been a significant change in insurance cost or coverage from year to year.

Conclusion: Joe can easily test the prepaid insurance and related insurance expense for 20X2 by comparing both the prepaid balance and insurance expense from year to year. Given the fact that both the 20X2 asset and expense are not materially different from 20X1, there is no need for the auditor to perform additional procedures, such as tests of the account balances.

Change the facts: Prepaid insurance and related expense are as follows:

	20X2	20X1
Prepaid insurance	$5,000	$23,000
Insurance expense	55,000	38,000

Conclusion: In performing an analytical procedure on prepaid insurance and insurance expense, there is a difference between the accounts from year to year. In fact, it looks like both the asset might be understated by $18,000 and the expense might be overstated by a similar amount.

Should Joe perform additional work on the prepaid insurance and expense?

Whether Joe expands his work to perform tests of the account balances is based on whether any difference (in this case $18,000) might be material to the financial statements. If not, Joe should pass on further work. If it is potentially material, Joe would perform additional audit procedures which might include: a) inquiry as to why the accounts have changed, and b) a test of the account balances such as a calculation of the prepaid insurance and expense.

Observation: The previous example illustrates a typical situation in practice involving a recurring prepaid asset or accrual. An effective way for an auditor to test all prepaid expenses and accruals that are recurring (such as prepaid insurance, accruals for payroll taxes, commissions, interest, etc.) is to test them analytically without engaging in a test of the detail of the account balance. In performing the analytical procedure, the auditor should test analytically the balance sheet balance (prepaid or accrual balance) and the related expense account. If the prepaid or accrual balance, and the related expense account are reasonably consistent from year to year, the auditor should refrain from performing additional audit procedures.

Auditing recurring prepaid and accrual accounts, and the related expenses, by testing the detail of those accounts should be avoided and performed as a last resort only when the results of the analytical procedures indicate that there might be a material variance.

Having the discipline to avoid detailed audit work in recurring prepaid and accruals items will save the auditor significant time without increasing audit risk.

XV. Practice Issues Relating to Auditing

A. Engagement Letter:

Question: Must an engagement letter be obtained for an audit?

Response: SAS No. 122, AU-C Section 210, *Terms of Engagement* (formerly SAS No. 108), requires that an understanding of the nature and terms of the engagement with the client be in writing. Thus, an engagement letter is required.

Prior to issuance of AU-C 210 (the formerly SAS No. 108), its predecessor, SAS No. 83 permitted the understanding to be achieved verbally or in writing. AU-C 210 eliminated the option of obtaining the understanding verbally and now requires it to be in writing.

Question: Must an engagement letter be signed by the client?

Response: No. AU-C 210 requires the understanding to be in writing, but does not require that it be signed by the client. Therefore, an accountant could send a client a one-way written communication, summarizing the terms of the agreement, and not require that the client sign that communication. Obviously, a one-way communication is risky because subsequent to the engagement being performed, the client could disavow that he or she agreed with the terms of the letter.

Observation: With respect to a compilation or review engagement, SSARS No. 21 requires that the engagement letter be signed by both management and the accountant. This dual signature requirement in SSARS No. 21 does not exist in auditing standards in AU-C 210.

B. Inventories:

1. Interim physical inventory observation

Facts: A company's year end is December 31. The company has always taken one physical inventory per year on September 30. At year end, the inventory is adjusted using an estimated gross profit. Perpetual inventory records are maintained. Joe CPA observes the physical inventory on September 30 and tests the valuation at December 31 calculated on the gross profit method.

Question: May the auditor rely on his interim observation as adequate evidence for supporting the year-end inventory valuation?

Response: Paragraph .A31 of SAS No. 122, AU-C Section 501, *Audit Evidence- Specific Considerations for Selected Items* states:

> *"For practical reasons, the physical inventory counting may be conducted at a date, or dates, <u>other than the date of the financial statements</u>. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system….."*

Therefore, it would appear that the above auditing procedures would be adequate.

Observation: Most auditors who observe the physical inventory at an interim date, roll forward the inventory to the year-end financial statement date by auditing the activity from the physical inventory observation date to the year-end financial statement date. For example, the auditor might

observe the inventory and value it at October 31, 20XX and then reconcile that inventory to December 31, 20XX by adding purchases during that period and deducting inventory sold. This reconciliation effort can be very time consuming. A more efficient approach may be to compute the gross profit percentage for the 10-month period ending October 31, 20XX, based on the audited interim inventory. Then, compute the ending inventory at December 31, 20XX using that same gross profit percentage computed at October 31, 20XX. This approach will save significant time and works best when there is a small window of time between the interim physical inventory date and the year-end date, such as one or two months.

2. Requirement to take a physical inventory

Question: Is the auditor required to observe any physical inventory if the inventory is material to the financial statements?

Response: No.

Paragraph .14 of AU-C 501, *Audit Evidence- Specific Considerations for Selected Items* states:

> *"If attendance at physical inventory counting is <u>impracticable</u>, the auditor should perform <u>alternative audit procedures</u> to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory….."*

Paragraph .A34 of AU-C 501 further states that factors that may be considered impracticable include nature and location of the inventory, such as when the inventory is held at a location that creates a <u>*safety threat*</u> to the auditor.

However, the AU-C further states that the matter of <u>*general inconvenience*</u> to the auditor is <u>*not sufficient*</u> to support a decision by the auditor that attendance is <u>*impracticable*</u>. Moreover, the matter of difficulty, time, or cost involved is not, in itself, a valid basis for the auditor to omit an audit procedure for which no alternative exists or to be satisfied with audit evidence that is less than persuasive.

What this means is that if an auditor can observe the physical inventory, the auditor should do so and not rely on alternative procedures in lieu of observing that inventory.

Example: Jimmy Jason, CPA is auditing Company X. X is taking its year-end physical inventory on Saturday, December 31, a day on which Jimmy typically watches football. In lieu of Jimmy observing the physical inventory, Jimmy wishes to perform alternative procedures on the inventory instead of observing the physical inventory.

Conclusion: Jimmy is permitted to perform alternative procedures in lieu of observing a physical inventory where it is impracticable to observe the physical inventory. However, Jimmy's failure to observe the inventory due to a general inconvenience (such as watching football), does not make the decision not to observe the physical inventory impracticable. Therefore, Jimmy should observe the inventory.

Moreover, the matter of difficulty, time or cost to observe the inventory (such as watching football) and the performance of alternative audit procedures that may be "less persuasive" is not a valid basis for Jimmy not to observe the inventory.

Change the facts: Assume that X is a manufacturer of toxic detergents and that it would be dangerous for Jimmy to observe the physical inventory.

Conclusion: The fact that the observation of the inventory would result in a safety threat to Jimmy means that it is not practicable for Jimmy to observe the inventory. The result is that he should perform alternative procedures.

3. Inventories- Using the gross profit method to roll forward physical inventory at interim

Question: Company X is a lumberyard with a calendar year-end. Historically, X has taken its physical inventory at December 31. However, because of the risk of snow and ice, X wants to take its physical inventory at November 30, based on the following approach:

- Take the physical inventory at November 30
- Compute a gross profit for 11 months through November 30
- Apply the gross profit percentage for the 11 months to compute the ending inventory at December 31.

Here are the actual numbers:

Ending inventory based on physical at November 30: $5,000,000

Gross profit computed based on physical inventory, 11 months ended November 30, 20X1:

Sales	$10,000,000
Gross profit (adjusted for 11-30 physical inventory)	7,500,000
Gross profit	2,500,000
GP %	25%

The next step is that X applies the gross profit percentage based on the November 30, 20X1 physical inventory, in computing the ending inventory at December 31, 20X1 as follows:

Computation of December 31, 20X1 Ending Inventory

	Inventory	Income statement

Sales		$12,000,000
Beginning inventory January 1, 20X1	$4,000,000	
Purchases	8,000,000	
Cost of goods sold	(8,700,000)	8,700,000
Ending inventory December 31, 20X1 perpetual	$3,300,000	
Entry to adjust ending inventory to reflect GP% of 25% based on 11-month financials	**(300,000)**	**300,000**
Ending inventory- 12-31-X1 per financial statements	$3,000,000	
Cost of goods sold- adjusted		9,000,000
Gross profit -12 months financial statements		$3,000,000
GP %		25%

Is it appropriate for the 12-31 ending inventory for financial statement purposes to be computed based on a gross profit percentage obtained using an interim physical inventory?

Response: Probably.

First of all, computing an ending inventory using an estimated gross profit percentage, when no physical inventory was taken during the year, is not acceptable for financial statement purposes. The gross profit method may be used to compute interim financial statements.

In practice, if a company performs a physical inventory at interim, the typical procedures performed by the company and audited by the auditor, involve rolling forward the interim inventory to year end by reflecting the purchases and cost of sales during the interim "stub" period. (The stub period is the period between the interim physical inventory and the year end.)

For example, if a physical inventory is taken at October 31 and the year end is December 31, the physical inventory at October 31 would be rolled forward to December 31 as follows:

Physical inventory at October 31	$XX
Add: Purchases November 1 to December 31	XX
Cost of goods sold- November 1 to December 31	(XX)
Ending inventory at December 31 per financial statements	$XX

However, rolling forward the inventory takes additional time and may not be that accurate. For example, a key element to the roll forward is the deduction of cost of goods sold during the November 1 to December 31 stub period. How is that cost of goods sold determined? If there is a perpetual inventory, the cost of goods sold may be determined based on the perpetual sales information. However, if there is no perpetual inventory system, gross profit during the stub period is likely computed by converting the stub period sales to cost of goods sold using an estimated

gross profit percentage. That gross profit percentage is nothing more than an estimate which begs the question as to whether any roll forward calculation is fully reliable.

So, now let's look at the example given. Is it acceptable to compute ending inventory using the gross profit percentage calculated based on the interim physical inventory?

The authority is found in AU-C 501, *Audit Evidence-Specific Considerations for Selected Items.*

Paragraph .12 of AU-C 501 states:

> "If physical inventory counting is conducted at a *date other than the date of the financial statements*, the auditor should, in addition to procedures required by paragraph .11 (e.g., typical audit procedures on inventory), perform audit procedures to *obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are recorded properly*."

Paragraph .A1 of AU-C 501 states:

> "For practical reasons, the physical inventory counting may be conducted at a date, or dates, *other than the date of the financial statements*. This may be done *irrespective of* whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system."

The fact is that auditing literature clearly provides the mechanism for auditing a physical inventory at an interim date as part of a year-end audit. What the literature does not address are the acceptable approaches that can be used to convert the interim physical inventory to the year-end inventory used in the financial statements. Another point is that AU-C 501 permits an interim physical inventory regardless of whether a perpetual inventory system is used. That means that if an entity does not have a perpetual system by which to roll forward a physical inventory to a year-end inventory, an entity can still use other procedures to convert the interim physical inventory to a year-end financial statement inventory.

Clearly, the risk that an auditor has to consider in allowing an interim physical inventory is driven by how reliable the data is within the stub period- that period between the physical inventory and the year-end.

When a traditional rollover is performed, the reliability of information rests in ensuring that the purchases and cost of sales within the stub period are reliable.

When a nontraditional rollover is performed using the interim gross profit percentage (per the example in this section), the reliability of information rests on the auditor being comfortable that the gross profit percentage on the sales within the stub period (one month in this example) is similar to the gross profit percentage within the previous 11 months. That means the auditor must expect that the product mix within the interim period must be similar to the gross profit for the entire year.

There are a few non-authoritative rules that should help an auditor make the decision as to whether to rely on an interim physical inventory to generate a gross profit percentage used to compute the ending inventory:

1. The shorter the stub period, the more likely that the auditor can expect that the gross profit percentage generated for the entire year is consistent with the gross profit percentage computed based on the interim physical inventory.

   Note: The author believes that a stub period of one to two months is acceptable.

2. The more homogeneous the products sold are in terms of individual item gross profit percentage, the easier it is to justify that the gross profit percentage for the entire year should be similar to the gross profit percentage computed based on the interim physical inventory.

   Note: If a company has a significant range of gross profit percentages within its product mix, it may be difficult for an auditor to rely on the fact that the gross profit percentage computed based on an interim physical inventory is similar to the gross profit percentage for the entire year, used to value the ending inventory.

Example 1: Company X sells one single type of widget, with all widgets sold at the same gross profit. X's year end is December 31 and X takes a physical inventory at November 30.

Conclusion: X should be able to compute a gross profit percentage based on the November 30, and then compute the ending inventory at December 31 using that same interim gross profit percentage. The reasons are twofold. First, X has one homogeneous product so that a change in product mix should not change the overall gross profit percentage. Second, the interim physical inventory was taken on November 30, so that the stub period to December 31 is only one month.

Example 2: Same facts as Example 1, except Company X has many types of products all with gross profit percentage ranging from a low of 10% to a high of 35%. Moreover, X takes its interim physical inventory at August 31.

Conclusion: X may not be a candidate for computing the December 31 ending inventory using the interim gross profit percentage based on the August 31 physical inventory. There are two reasons for this conclusion. First, X does not have a homogenous product line. Therefore, the product mix of sales at interim could significantly differ from the annual sales product mix. Second, the interim physical inventory was taken on August 31, resulting in a four-month stub period. Although not authoritative, the author believes that a four-month spread between the physical inventory date and the ending inventory is too long to use an interim gross profit percentage to value the year-end inventory.

Testing lower of cost or market (LCM) for inventories in the aggregate

Question: Joe, an auditor, is sick and tired of testing lower of cost or market on inventory on an individual item basis. Joe, an avid golfer, wants to spend more time on the golf course and less time performing tedious lower of cost or market tests.

He wants to test lower of cost or market in the aggregate by combining major inventory items and performing one LCM test for those sampled items.

Does GAAP permit lower of cost or market inventory tests in the aggregate instead of testing it item by item?[33]

Response: Yes. ASC 330-10-35-8, *Inventory- Overall- Subsequent Measurement*, states that "*the rule of lower of cost or market value may properly be applied either directly to each item or to the total of inventory ….*"

A high risk area for auditors is inventory existence and valuation. It is not unusual for a creditor to sue a CPA firm for inventory that either does not exist or that is obsolete. Therefore, it is critical for an auditor to test two assertions of inventory:

- Existence- make sure the inventory actually exists
- Valuation- inventory is recorded at lower of cost or market

Obviously, one effective way to test inventory existence is by observing the physical inventory and tracing test counts into the final physical inventory.

When it comes to valuation, auditors spend too much time testing individual inventory items for lower of cost or market value, and avoid looking at the big picture. A common audit approach is to do one of the following:

- Examine recent invoices to test unit costs used to value the ending inventory
- Doing extensive cost build-up tests to test standard costs for manufacturers

Although both of these tests can be effective, they do not necessarily test the "big picture" and the greater risk that there is a lower of cost or market value problem.

There is another test that can be performed to protect the auditor from risk of obsolescence and a failure to write down the inventory to lower of cost or market.

The test is to determine whether there is adequate hypothetical gross profit (normal profit) in the ending inventory. What this means that is when the ending inventory is ultimately sold in the next year, will there be sufficient gross profit generated from the inventory based on the costs included in the ending inventory valuation? If not, the inventory is overstated. If yes, the inventory is properly valued and there is unlikely a lower of cost or market problem. The test is done in the aggregate based on a sample of inventory items.

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[33] The FASB issued ASU 2015-11: *Inventory (Topic 330) Simplifying the Measurement of Inventory* which eliminates use of the lower of cost or market for FIFO and average cost inventories and replaces it with lower of cost and net realizable value. The changes made by the ASU are effective for calendar year 2017 and applied prospectively to the December 31, 2017. The changes made by the ASU are not reflected in the example as the changes are not yet in effect.

Steps to test

Take a sample of the ending inventory consisting of the items that have significant value relative to the total inventory. Extend the quantities in the sample based on the selling prices obtained from the year-end sales price list as follows:

a. Compute the sales that will be generated when the sample is ultimately sold.

b. Apply an estimate of discounts and allowances to the gross sales, based on the percentage in the current year.

c. Compute a hypothetical gross profit when the inventory is sold.

d. Compare that hypothetical gross profit percentage to the expected gross profit for the current year.

e. If the hypothetical gross profit computed from the sample equals or exceeds the expected gross profit, there is adequate gross profit in the ending inventory so that there is no lower of cost or market problem.

Note: The hypothetical gross profit percentage should actually exceed the expected gross profit percentage to provide a cushion for inventory shrinkage in the next period.

Test of Gross Profit in the Inventory- Per Sample					
Item	**Quantity**	**Unit cost**	**Total cost**	**At unit selling prices (a)**	**At selling price**
100	10,000	$1	$10,000	2	$20,000
105	20,000	2	40,000	3	60,000
107	30,000	1	30,000	2	60,000
200	30,000	8	240,000	12	36,000
210	20,000	9	180,000	15	300,000
212	13,000	1	13,000	2	26,000
230	12,000	2	24,000	3	36,000
240	30,000	5	150,000	8	240,000
260	40,000	3	120,000	5	200,000
262	25,000	2	50,000	4	100,000
268	20,000	3	60,000	5	100,000
340	35,000	4	140,000	7	245,000
350	80,000	9	720,000	14	1,120,000
355	35,000	8	280,000	13	455,000
378	90,000	10	900,000	14	1,260,000
380	25,000	14	350,000	18	450,000
382	20,000	20	400,000	26	520,000
Per test			**$3,707,000**		**$5,228,000**
Total ending inventory valuation			$12,000,000		
% tested			31%		
(a) Obtained from the actual year-end sales price list.					

TEST OF HYPOTHECAL GROSS PROFIT IN ENDING INVENTORY- PER SAMPLE

Gross sales	$5,228,000
Estimated discounts and allowances 5% (1)	(261,400)
Hypothetical net sales when inventory is sold	4,966,600
Cost of sales	3,707,000
Hypothetical gross profit in inventory sample	$1,259,600
Hypothetical gross profit in ending inventory	25%
Expected gross profit based on current year and prior year	23%

(1) Based on actual per current year

Conclusion: Based on the sample, when that inventory is ultimately sold, the company expects to receive a gross profit of 25%, which is slightly higher than that expected gross profit (based on the actual current year and the previous year). This means is that there is sufficient gross profit in the sample of the ending inventory, indicating that no lower of cost or market problem exists. Note further that the hypothetical gross profit should be slightly higher than the expected gross profit percentage to reflect potential shrinkage in the following year.

Change the facts: Assume that the expected gross profit percentage is only 18% based on the sample, computed as follows:

Test of Gross Profit in the Inventory- Per Sample					
Item	**Quantity**	**Unit cost**	**Total cost**	**Unit SP**	**At SP**
100	10,000	$1	$10,000	$2	$20,000
105	20,000	2	40,000	3	60,000
107	30,000	1.50	45,000	2	60,000
200	30,000	9	270,000	12	36,000
210	20,000	11	220,000	15	300,000
212	13,000	1	13,000	2	26,000
230	12,000	2	24,000	3	36,000
240	30,000	5	150,000	8	240,000
260	40,000	3	120,000	5	200,000
262	25,000	2	50,000	4	100,000
268	20,000	3	60,000	5	100,000
340	35,000	4	140,000	7	245,000
350	80,000	9	720,000	14	1,120,000
355	35,000	8	280,000	13	455,000
378	90,000	12	1,080,000	14	1,260,000
380	25,000	14	350,000	18	450,000
382	20,000	25	500,000	26	520,000
Per test			**$4,072,000**		**$5,228,000**
Total ending inventory valuation			$12,000,000		
% tested			34%		

TEST OF HYPOTHECAL GROSS PROFIT IN ENDING INVENTORY- PER SAMPLE:

Gross sales	$5,228,000
Estimated discounts and allowances 5% (1)	(261,400)
Hypothetical net sales when inventory is sold	4,966,600
Cost of sales	4,072,000
Hypothetical gross profit in inventory sample	$894,600
Hypothetical gross profit in ending inventory (sample)	**18%**
Expected gross profit based on current year and prior year	23%

(1) Based on actual per current year

Conclusion: That result suggests that there is not a normal gross profit of at least 23% in the ending inventory. Instead, there is only an 18% gross profit in the ending inventory, which indicates that ending inventory is overstated and there is a lower of cost or market value problem.

As a result, the auditor should perform a lower or cost or market (LCM) test in the aggregate (instead of item by item) using the following approach based on the same sample.

Take the same sample and extend it at replacement cost (using current invoices at or near year end).

Test of LCM- Sample

Item	Quantity		Unit cost		Total cost	At SP	Unit RC	Total RC
100	10,000			$1.00	$10,000	$20,000	$1.20	$12,000
105	20,000			2.00	40,000	60,000	1.80	36,000
107	30,000			1.50	45,000	60,000	.80	24,000
200	30,000			9.00	270,000	36,000	6.70	201,000
210	20,000			11.00	220,000	300,000	11.00	32,000
212	13,000			1.00	13,000	26,000	1.40	18,200
230	12,000			2.00	24,000	36,000	2.30	27,600
240	30,000			5.00	150,000	240,000	4.20	126,000
260	40,000			3.00	120,000	200,000	2.40	96,000
262	25,000			2.00	50,000	100,000	1.80	45,000
268	20,000			3.00	60,000	100,000	3.70	74,000
340	35,000			4.00	140,000	245,000	3.50	122,500
350	80,000			9.00	720,000	1,120,000	7.70	616,000
355	35,000			8.00	280,000	455,000	9.20	322,000
378	90,000			12.00	1,080,000	1,260,000	10.60	954,000
380	25,000			14.00	350,000	450,000	15.40	385,000

382	20,000		25.00	500,000	520,000	13.00	260,000
Per test				**$4,072,000**	**$5,228,000**		**$3,351,300**
Total ending inventory valuation				$12,000,000			
% tested				34%			

Lower of cost or market test can be done for the entire ending inventory, using the same sample, grossed up to the population as follows:

TEST OF LCM PER SAMPLE:

STEP 1: COMPUTATION OF MARKET VALUE:

Replacement cost (RC), subject to a ceiling and floor:

Selling price	$5,228,000
Estimate costs to sell, and dispose of the item	(261,400)
Net realizable value CEILING (HIGHEST RC)	4,966,600
Normal gross profit (23%)	(1,142,000)
FLOOR (LOWEST RC)	3,824,600
Replacement cost per sample	3,351,300
MARKET VALUE = Replacement cost (FLOOR) (A)	3,824,600

STEP 2: DETERMINE COST:

COST (B)	4,072,000
LCM (lower of (A) or (B))	**$3,824,600**

If one performs the hypothetical test of gross profit in the inventory sample, it now looks like this:

TEST OF HYPOTHECAL GROSS PROFIT IN ENDING INVENTORY- PER SAMPLE

Gross sales	$5,228,000
Estimated discounts and allowances 5% (1)	(261,400)
Hypothetical net sales when inventory is sold	4,966,600
Cost of sales **(LCM per sample)**	3,824,600
Hypothetical gross profit in inventory sample	$1,142,000
Hypothetical gross profit in ending inventory	23%
Expected gross profit based on current year and prior year	23%

(1): Based on actual per current year

The result is that there is a 23% normal gross profit in the ending inventory sample that should be generated when the sample is ultimately sold next year.

The last step is to write down the entire ending inventory to lower of cost or market value (LCM) based on LCM for the sample as follows:

LCM per sample	$3,824,600
% tested	34%
LCM entire inventory	11,248,000
Valuation at cost	12,000,000
Allowance for writedown	$752,000

Conclusion: The company should write down the inventory by $752,000 to $11,248,000 either by recording an allowance for writedown or writing the inventory down to $11,248,000, as follows:

Entry:

Cost of goods sold	752,000	
Allowance for writedown (or inventory)		752,000

To write inventory down to LCM from 12,000,000 to 11,248,000.

LCM and manufacturers:

The previously presented lower of cost or market value test is very useful particularly with manufacturers. With manufacturers, there is the risk that too much fixed burden (overhead) is

added to the ending inventory, particularly when manufacturing volume declines. The LCM test will uncover a situation in which the inventory is overstated and there is not sufficient normal gross profit in the ending inventory.

Note: In 2015, the FASB issued ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory.*

The ASU amends ASC 330, *Inventory*, to change the way in which inventory is valued. Under the ASU:

1. Use of the lower of cost or market method to value inventory is no longer in effect.

2. Upon the effect date of the ASU, an entity should measure inventory valued at FIFO or average cost at the *lower of cost and net realizable value* and not lower of cost or market.

3. Net realizable value is defined as the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.

4. Measurement is unchanged for inventory measured using LIFO or the retail inventory method.

5. The amendments in the ASU bring the GAAP rules more in line with the measurement of inventory in International Financial Reporting Standards (IFRS).

6. The changes in the ASU are effective as follows:

    - For public business entities, the ASU is effective for fiscal years beginning after December 15, 2016.

    - For all other entities (including nonpublic entities), the ASU is effective for fiscal years beginning after December 15, 2016. The amendments are applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period.

C. Confirmation Procedures:

Question: Historically, auditors have had difficulty obtaining receivable confirmation replies from large corporations and government organizations. What audit procedures should be used in this situation?

Response: In this situation, the auditor has no choice but to *perform alternative auditing procedures* including, but not limited to:

- Examination of invoices included in the aging
- Collection of the receivable balances (realization test)
- Test of sales cutoff
- Analytical procedures

Confirmation of bank loans/capital lease obligations:

Question: It is often difficult for banks to confirm loan balances. This includes the balance on a capital lease obligation. What alternative procedures should be performed?

Response: While the debtor may not be able to calculate the loan or obligation balance, there are details that the debtor may confirm from which the auditor can adapt. For example, a bank can confirm the original loan balance and terms. From this, the auditor can "roll forward" the balance from the previous year's balance. This would be deemed an acceptable auditing procedure.

Using postage-paid return envelopes:

Question: Does GAAS require that an auditor use postage-paid return envelopes for positive confirmations?

Response: No. GAAS ***does not require*** the use of return envelopes; however, in practice, most auditors use return envelopes to facilitate responses.

D. Auditing Cash:

Question: Most major banks will not confirm cash balances using the standard bank confirmation. What options does an auditor have in verifying the cash balance from the third party bank?

Response: Assuming cash is material, an auditor can use alternative procedures to confirm the cash balance.

First of all, there is no requirement within GAAS that an auditor confirm cash. Although it is true that a confirmation of a cash balance directly with a bank is stronger corroborating evidence than accepting a client's copy of a bank statement. Yet, in many instances, obtaining a confirmation from a bank may not be possible and alternative procedures may be warranted.

One alternative procedure is for the auditor to request that the client give the auditor the end of year bank statement directly unopened. The auditor can make a copy of the statement and give the statement back to the client to complete the year-end bank reconciliation. Some commentators believe that receiving the bank statement from the client is subject to client manipulation of the bank statement before it is given to the auditor. The reality is that if the client opens the bank statement before handing the statement to the auditor, the auditor will know that the glued seal on the envelope has been broken.

A second option is for the auditor to ask the client to pull up the electronic bank statement on line at the bank's web site in the presence of the auditor. At that point, the auditor can inspect the electronic bank statement on line, and print out a copy of the bank statement and any canceled checks directly from the bank's web site.

The reader should note that if the auditor does, in fact, pull up the electronic bank statement on line with the assistance of the client (and not the bank), any evidence obtained is *not considered an external confirmation*.

AU-C Section 505: *External Confirmations*, defines an external confirmation as:

> *"Audit evidence obtained as a direct written response to the auditor from a third party, either in paper form or by electronic or other medium, such as through the auditor's direct access to information held by a third party."*

In order for access to an on-line bank account to be considered an external confirmation, the auditor must obtain the direct access and the related electronic access codes directly from the bank, and not the client. However, because there is no requirement that the auditor confirm cash with the bank, obtaining evidence of a cash balance by accessing the on-line bank account with the assistance of the client, and not the bank, is acceptable audit evidence in most instances.

Question: How important is it to ask for cutoff bank statements at year-end in order to clear all items in the client's year-end bank reconciliation?

Response: In general, most banks will not send cutoff statements and, if they do, the timing of receipt of the statement may be too late relative to the timing of the audit engagement.

An alternative to receiving a cutoff statement is to ask the client to deliver the next bank statement after year end to the auditor unopened. For example, if an audit is conducted as of December 31, instead of asking for a cutoff statement as of January 15, the auditor should wait and receive the January 31 bank statement directly from the client unopened. How does the auditor know that the client did not open the statement? It is quite obvious. With most bank statements, once the statement is opened, the envelope flap is altered because of the strong glue that is used to secure the seal.

Another option is for the auditor to ask the client to go on-line and look up the bank account directly on the bank's web site. At that time, the auditor can review checks clearing after year end.

Question: What alternative procedures might an auditor use to verify endorsements on checks when the client's bank does not return canceled checks with the bank statements?

Response: Verifying endorsements on the back of canceled checks is not a required auditing procedure. Yet, an auditor may decide that this procedure is necessary given his or her assessment of inherent and control risk. As a general rule, if the auditor is simply testing a bank reconciliation, the need to verify endorsements on the back of canceled checks is usually not required and beyond the scope of the audit objective. If, however, the auditor seeks the endorsements as a part of a test to reduce control risk or other audit procedure, the auditor can apply the following additional procedures:

a. Ask the client to go directly to the bank's web site and pull up the electronic version of the bank account. From there, the auditor can select canceled checks and inspect the endorsement on the bank of those selected checks.

b. Select the checks and order copies of those canceled checks directly from the bank.

Note: You should expect that the bank will charge the client a fee for copying the checks if those checks are not included in the electronic versions of the bank statements.. Further, it is likely that the bank will take 30 to 60 days to send copies of checks. This time delay should be factored in when planning the audit.

Observation: With the use of on-line banking, the need for an auditor to confirm bank account balances and obtain cut-off bank statements is passé. The author believes the most effective approach for an auditor (and one that saves administrative time) is for the auditor to ask the client to go online and open the bank account and allow the auditor to inspect the bank statement(s), canceled checks and other transactions. One key point to consider is that most banks retain only 18 months of bank statements on line. That means that it is critical that the auditor make sure that he or she is within the 18-month window to retrieve on-line electronic bank statements. For most audits that are performed within three or four months of year end, the auditor could be required to go back a total of 15 to 16 months (12 months plus three or four months after year end), so that there should be no problem obtaining all on-line electronic bank statements.

However, if the audit engagement is delayed for whatever reason, the auditor may wish to perform the on-line banking procedures early in the auditor or risk that the 18-month window for reviewing bank statements on-line is not closed.

E. Auditing Cash Basis Financial Statements:

Facts: An auditor is auditing the financial statements of a company that reports on the cash basis of accounting. The Company has material balances in its trade receivables or payables, both of which are not presented on the cash basis balance sheet.

Question: Does GAAS apply? What auditing procedures should the auditor conduct with respect to the receivables and payables?

Response: GAAS applies to GAAP statements as well as those statements prepared on special purpose framework such as cash basis financial statements. Because the receivables and payables are not presented on the balance sheet, *confirmation or the conducting of other substantive tests is not required*. With respect to the completeness of revenue and expenses, they can be tested via cash receipts and disbursements. Therefore, again, no substantive tests are needed with respect to receivables and payables. The exception may be where the auditor believes that confirmation is needed for the auditor to comply with AU-C 240 (formerly SAS No. 99), *Consideration of Fraud in a Financial Statement Audit*, whereby the auditor establishes control risk at maximum and he/she is concerned about the possibility of fraud.

F. Legal Letters:

Facts: As part of her audit, Mary Auditor, CPA examines legal and accounting expense. She notices several invoices were paid as follows:

Billy Slime, Esq.	Legal work-uncollected accounts receivable
Johnny Plaid, Esq.	Patent work
Dewey, Charge and Howe Attorneys at Law	Estate planning work in connection with revision of shareholder stock redemption agreements
Robert Arsenalt, Esq.	Legal fee in connection with bail out of owner's son from drug dealing and car theft

Mary asks the client to prepare four legal letters for the above. The client's controller, Bill Salami doesn't want to send out the letters because each lawyer charges $500 for a reply. He further states that there are no unasserted claims and assessments against the company.

Question: Should Mary send out legal letters to comply with GAAS?

Response: Probably not. Lawyers generally charge for the time spent on responding to legal letters. This practice has brought to the forefront the issue of when an auditor must obtain legal letters to comply with SAS No. 122, AU-C Section 501, *Audit Evidence-Specific Considerations for Selected Items* (formerly part of SAS No. 12),[34] and when, such responses are meaningful.

AU-C 501 provides a *two-step approach* for an auditor to address litigation, claims and assessments.

Step 1: The auditor is required to design and perform certain audit procedures to identify litigation, claims, and assessments that may give rise to the risk of a material misstatement.

That effort includes:

a. Inquiring of management and others within the entity (including in-house legal counsel) as to whether there is any litigation, claims, or assessments.

b. Obtaining from management a description and evaluation of any litigation, claims, and assessments, including any matters that were referred to legal counsel (both in-house and external counsel).

c. Reviewing minutes of board meetings, and

d. Reviewing legal expense accounts and invoices from legal counsel.

Step 2: Once Step 1 is completed, the auditor should identify any actual or potential litigation, claims or assessments and evaluate them for the:

[34] Effective December 31, 2012, AU-C 501, *Audit Evidence- Specific Considerations for Selected Items* replaces SAS No. 12.

- Period in which the underlying cause for legal action occurred
- Degree of probability of an unfavorable outcome, and
- Amount or range of potential loss.

Now to whether lawyers' letters have to be sent out to all lawyers.

AU-C 501 requires that the auditor should seek direct communication with the entity's external legal counsel in connection with *actual or potential litigation, claims, or assessments* that may give rise to a risk of material misstatement.

That communication should be performed through a lawyer's letter of inquiry prepared by management and sent by the auditor requesting that the external lawyer communicate directly to the auditor.

Therefore, a lawyer's letter *should be sent only in connection with any identified actual or potential litigation, claims or assessments* that may give rise to a risk of material misstatement. f no such litigation, claim or assessment is identified, no lawyer's letter should be sent.

If no lawyer's letter is sent because no such litigation, claims or assessments were identified, the auditor should include language in the management representation letter similar to the following:

> Example of language to include in management's representation letter:
> *"We are not aware of any pending or threatened litigation and claims whose effects should be considered when preparing the financial statements [and we have not consulted legal counsel concerning litigation or claims]."*
>
> Optional language to add:
> *"We have not consulted a lawyer concerning litigations, claims, or assessments."*

Observation: A common mistake auditors make in practice is to send lawyers letters out to all lawyers as part of the Step 1 to identify litigation, claims, and assessments that may give rise to the risk of a material misstatement.

The auditor should not be sending out a lawyer's letter to various lawyers to search for and identify litigation, claims and assessments that may give rise to the risk of a material misstatement. Instead, the auditor should first perform various procedures to identify litigation, claims and assessments that may give rise to the risk of material misstatement. Those procedures include:

a. Inquiring of management and others within the entity (including in-house legal counsel) as to whether there is any litigation, claims, or assessments.

b. Obtaining from management a description and evaluation of any litigation, claims, and assessments, including any matters that were referred to legal counsel (both in-house and external counsel).

c. Reviewing minutes of board meetings, and

d. Reviewing legal expense accounts and invoices from legal counsel.

Once the above procedures are performed, the auditor should identify any actual or potential litigation, claims or assessments and evaluate them. Then, and only then, should the auditor ask management to prepare a lawyer's letter and have the auditor send out that letter.

The point is that the auditor should not be sending out a lawyer's letter blindly in an effort to search for actual or potential litigation, claims or assessments that may give rise to the risk of a material misstatement.

G. Unusual Reporting Issues:

Question: If an auditor is engaged to conduct a review under the SSARSs, is he or she permitted to perform selected auditing procedures and still issue a review report?

Response: Yes. Performing certain audit procedures, such as confirmation of receivables or observation of inventory, may be requested by clients in connection with a review engagement. The accountant must still issue a review report because audit level assurance has not been obtained on the financial statements taken as a whole.

In addition, when an accountant, in connection with a compilation or review engagement, plans to perform procedures that are customarily applied during an audit, he or she may wish to place additional importance on whether a written engagement letter should be obtained from the client.

Further, in using confirmation requests or other communications in a review engagement, the accountant should not use phrases such as "part of an audit of the financial statements." Instead, recommended language might look like this:

> "As part of our ***review (compilation)*** of the financial statements of XYZ Corporation for the year ended December 31, 20XX, we request that you confirm the following information....."

Question: What are the procedural and reporting considerations in an audit engagement when the auditor does not have the appropriate level of assurance on the opening financial statement balances? An example is where an auditor audits financial statements covering a period in which he or she did not observe the opening physical inventories.

Response: Although the auditor may not have observed the beginning inventory or audited other accounts, he or she may, nevertheless, be able to become satisfied as to such prior balances by applying alternative procedures such as testing prior transactions, review of the records of prior counts, application of gross profit tests, etc. If comfort can be obtained, the auditor can issue an unmodified opinion on all financial statements for that period.

If, however, the auditor cannot obtain comfort on the opening balances by applying alternative procedures, the auditor may do the following:

Option 1: Perform a balance sheet only audit for the current year, or

Option 2: Express an unmodified opinion on the current balance sheet, and a modified opinion (qualified opinion or disclaimer) on the other financial statements (e.g., income statement, cash flow statement, statement of equity).

Note: Effective December 31, 2012, the term "unqualified opinion" is replaced with the term "unmodified opinion."

Question: May an auditor audit the balance sheet and review the income statement, statement of cash flows, and statement of retained earnings?

Response: There is no specific literature that prevents an auditor from doing this. AU-C Section 705, *Modifications to the Opinion in the Independent Auditor's Report*, permits an auditor to express an unmodified opinion on one financial statement and issue a modified opinion (e.g., qualified, adverse or disclaimer opinion) on other statement(s) if the circumstances warrant. Further, AU-C 705 does not specifically permit or prohibit the audit of one statement and the review or compilation of the other(s).

This situation could be somewhat effective where an auditor has a scope limitation relating to the opening balances. Instead of issuing a qualified or disclaimer opinion on the statements of income, cash flow and retained earnings, the auditor may wish to issue a review report to provide the client with some level of assurance. However, the auditor must be careful that the third party user and client are not confused about the two levels of service.

H. Issuing Comfort Letters to Client Lenders:

It is common for a client to ask an accountant to prepare a letter addressed to a prospective letter, supplying certain tax and financial information in connection with the underwriting of a loan. Lenders use the accountant's information to assess a borrower's creditworthiness and verify the accuracy of information provided to them by the borrower.

Examples of requested information may include:

- Confirmation of a client's self-employed status
- Verification of income from self-employment
- Profitability of a client's business
- The impact on a client's business if money is withdrawn to fund the down payment on a real estate purchase

How may an accountant respond to a request from a client, lender, or loan broker to confirm client information in connection with a pending loan application?

Reply: Previously, the AICPA issued guidance on this issue in *TIS Section 9110, Special Reports .19 Lender Comfort Letter*.

When presented with such requests, the accountant should consider the guidance in Interpretation No. 2, "*Responding to Requests for Reports on Matters Relating to Solvency*," of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, AT sec. 9101 par. .23–.33). Paragraph .27 of Interpretation No. 2,[35] states that a practitioner is precluded from giving any form of assurance on matters relating to solvency or any financial presentation of matters relating to solvency.

Paragraph .25 of Interpretation No. 2 defines matters relating to solvency as whether an entity (*a*) is not insolvent at the time the debt is incurred or would not be rendered insolvent thereby, (*b*) does not have unreasonably small capital, or (*c*) has the ability to pay its debts as they mature.

In response to a request to confirm client information in connection with a pending loan application, an accountant may provide a client with various professional services that may be useful with a financing. Those services include:

- An audit, a review, or a compilation of personal financial statements.
- An examination, a review, or a compilation of pro forma personal financial information.
- An examination or a compilation of prospective personal financial statements.
- An agreed-upon procedures report, as long as the agreed-upon procedures do not provide any assurance on matters related to solvency.

Additionally, a broker or lender may be satisfied with a copy of the client's income tax return and a letter from the accountant, including an acknowledgment that the income tax return was prepared by the accountant. Obtaining client consent before providing any confidential information to a third party is required under professional ethics standards, the Gramm-Leach-Bliley Act, the Internal Revenue Code, and federal and state privacy statutes and regulations.

The following is a sample letter that may be used in this situation:

Date XYZ Bank
Address City, State Zip

Dear Mr. Jones:

I am writing to you at the request of Mr. and Mrs. Smith.

[35] Effective for reports dated on or after May 1, 2017, SSAE No. 18, *Attestation Standards: Clarification and Codification*, supersedes most of the attestation standards currently found in SSAE No. 10-17, including AT section 101 and all interpretations related to AT section 101. Although all interpretations, including Interpretation No. 2, are superseded by SSAE No. 18, its guidance is still relevant and should be followed until the Auditing Standards Board issues new guidance as a companion to SSAE No. 18.

The purpose of this letter is to confirm to you that I prepared the 2016 federal income tax return of Mr. and Mrs. Smith and delivered this return to them for filing with the IRS. At their request, I have attached a copy of the tax return and related schedules provided to them for filing.

Optional additional language in italic
Mr. & Mrs. Smith provided the firm with a signed and dated copy of IRS Form 8879, which includes a declaration that they examined a copy of their electronic individual income tax return and accompanying schedules and statements for that tax year and declared that it is true, correct, and complete to the best of their knowledge.[36]

This return was prepared from information furnished to me by Mr. and Mrs. Smith. This information was neither audited nor verified by me, and I make no representation nor do I provide any assurance regarding the accuracy of this information or the sufficiency of this tax return for your credit decision-making purposes.

I prepared Mr. and Mrs. Smith's tax return in accordance with the applicable IRS rules and regulations solely for filing with the IRS. As a result, the tax return does not represent any assessment on my part regarding creditworthiness and does not include any statement of their financial position or income and expense for the year 2016, in accordance with accounting principles generally accepted in the United States of America, and should not be construed to do so.

As you know, a credit decision should be based on a lender's exercise of due diligence in obtaining and considering multiple factors and information. Any use by you of Mr. and Mrs. Smith's 2016 federal income tax return and this letter is solely a matter of your responsibility and judgment. This letter is not intended to establish a client relationship with you nor is it intended to establish any obligation on my part to provide any future information to you with regard to Mr. and Mrs. Smith.

Optional additional language:
To the best of my knowledge and belief, John Smith is self-employed.

John Smith's 2016 self-employment income, as presented on Mr. and Mrs. Smith's 2016 Form 1040, Schedule C was $150,000.

Sincerely,

Jimmy James, CPA

cc: Mr. and Mrs. Smith

[36] Additional language supplied in *Third Party Verification Letters*, CNA, November 2012.

Sample Letter: Accountant is Asked to Confirm Employment

Date

Mr. Sam Jones
Vice President
XYZ Bank
Address City, State Zip

Dear Mr. Jones:

I am writing to you at the request of Mr. and Mrs. Smith.

The purpose of this letter is to state that *to the best of my knowledge and belief, Mr. John Smith is self-employed.*

Sincerely,

Jimmy James, CPA

cc: Mr. and Mrs. Smith

Other options to provide information to lenders or third parties

If an accountant does decide to submit information to a lender on behalf of the client, there are a few rules that should be followed to protect the accountant for additional liability:

1. By supplying any information directly to a lender, the accountant may be creating a nexus between the lender and accountant that may not otherwise exist, thereby giving the lender a basis for a future lawsuit.

2. The accountant *should not*:

   - Make any statements that give any form of assurance as to the accuracy of the information
   - Verify income but can reiterate amounts that are listed on the tax return.
   - Provide any form of assurance that an entity is not insolvent or would not be rendered insolvent if a certain action or condition occurs.

     Note: An accountant *should not* provide any form of assurance that an entity:

     - Is not insolvent at the time the debt is incurred or would not be rendered insolvent if certain actions or conditions occur
     - Does not have unreasonably small capital, or
     - Has the ability to pay its debts as they mature.

3. If the accountant is asked to state that the client is self-employed, statements such as the following should be used:

   To the best of my knowledge and belief, John Smith is self-employed, or

John Smith has informed me that he is self-employed.

4. If the accountant does send the information directly to the lender or third party, the accountant must get the client's written consent.

   Note: One malpractice insurance company states that if a client asks for copies of his or her tax returns and the accountant is aware that the returns will be given to third parties, the accountant may wish to include additional language in the transmittal letter as follows:

   "We prepared the tax returns solely for filing with the Internal Revenue Service (IRS) and state and local tax authorities. They are not intended to benefit or influence any third party, either to obtain credit or for any other purpose.

   As a result, you agree to indemnify and hold our firm and any of its partners, principals, shareholders, officers, directors, members, employees, agents or assigns harmless from any and all claims arising from the use of the tax returns for any purpose other than filing with the IRS and state and local tax authorities, regardless of the nature of the claim, including the negligence of any party."

Changes in the Freddie Mac requirements for comfort letters

Freddie Mac updated its guide for underwriting loans on single family houses. As part of the revisions to the Guide, Section 37.13(b), *Self-Employed Income*, removes the existing option for the underwriter to obtain a letter from an accountant to confirm that the use of business assets for the down payment or to close the loan will not have a detrimental impact on the business.

Now, such a letter from an accountant is no longer an option. Instead, under the revised Freddie Mac Guide, the underwriter must verify the funds using specific documentation requirements found in the Guide.

The result is that an underwriter should no longer ask an accountant for a letter stating that the business assets used for the down payment will not have a detrimental effect on the business.

Fannie Mae underwriting never offered the option to obtain an accountant's letter.

Now that both Freddie Mac and Fannie Mae do not allow the underwriter the option to obtain an accountant's letter, it will be rare for accountants to get such a request unless it is made from a bank that plans to hold the mortgage in house. Regardless of whether such a requirement is received, accountants should avoid issuing any letter that provides any type of verification of down payment or assurance that the use of the down payment will not be detrimental to the business.

I. Management Representations Regarding Prior Periods Presented That Were Audited by Predecessor Auditor

When an auditor becomes a successor auditor, there is a question as to whether the successor auditor is required to obtain a representation letter for the prior periods presented comparatively that were audited by the predecessor auditor.

Is the auditor required to obtain a representation letter covering the prior period financial statements?

Reply: No.

Guidance on this issue is found in TIS Section 8900, *Predecessor Auditors, .11 Management Representations Regarding Prior Periods Presented That Were Audited by Predecessor Auditor provides guidance.*

Paragraph .20 of AU-C section 580, *Written Representations* (AICPA, Professional Standards), requires that written representations be obtained for all financial statements and period(s) referred to in the auditor's report. Paragraph .52 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, Professional Standards), states that:

> "as required by section 580, *Written Representations*, the auditor should request written representations for *all periods* referred to in the auditor's opinion."

The prior period financial statements were audited by a predecessor auditor, and the predecessor auditor's report on the prior period's financial statements is not reissued. The auditor's report will express an opinion on the current period's financial statements and will include an other-matter paragraph in accordance with paragraph .54 of AU-C section 700.

Written representations confirm audit evidence used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Because the auditor is *not opining on the prior year* when making reference to the prior period that was audited by a predecessor auditor, the auditor is not required to obtain a representation letter covering the prior period financial statements.

However, the auditor may request current-year written representations with respect to audit work that the auditor performs relative to opening balances and may include written representations for such items as consistency in accounting policies, prior year internal control deficiencies, and matters relating to report modifications. Additional representations may be necessary in the current year's letter if the successor auditor discovers material misstatements in the prior year's financial statements; restatement is necessary; and the auditor audits the restatement adjustments.

J. Signing and Dating Audit Reports- Naming the City and State Where the Auditor

Inquiry: Paragraph .40 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), states that the auditor's report should "name the city and state where the auditor practices." May the auditor comply with this requirement by issuing his or her report on the firm's letterhead that contains the city and state where the auditor practices?

Reply: TIS Section 9100, *Signing and Dating Reports, .07 Naming the City and State Where the Auditor*
provides guidance.

The city and state where the auditor practices is *not required* to be placed under the auditor's signature and may be named in the firm's letterhead on which the report is issued.

XVI. Study on Public Perception of Accountants in Jury Trials

A Gallup Poll[37] concluded that the image of the accounting profession has improved close to its pre-Enron level even though it has taken more than a decade to do so.

Specifically, 39 percent of those polled had a high or very high rating of accountants in terms of being honest and ethical. Compare the 39 percent threshold with a low of 32 percent in 2002, during the Enron fiasco. The pre-Enron high was 47 percent.

Favorability ratings from the Poll for various professions were:

- Clergy 45%
- ***Accountants 39%***
- Bankers 25%
- Lawyers 21%
- Lobbyists 7%
- Nurses 85%
- Medical doctors 67%
- Car salesmen 8%
- Members of Congress 8%

Regardless of how the public perceives the accounting profession as a whole, one study suggests that there continues to be a significant disconnect between the perceived responsibility accountants have to their clients and third parties, and their actual responsibilities.

Camico Mutual Insurance Co. published a report entitled, *Public Perceptions in a "Post Enron" World*, based on a survey of the American public. The purpose of the survey was to investigate potential juror attitudes towards accountants and whether those attitudes have been negatively affected by corporate scandals.

General conclusions reached from the survey include:

In the post-Enron environment, 78% of those surveyed believe the things they hear in the news about corporate wrongdoing.

1. 61% of respondents believe that accountants are responsible for making sure their clients stay honest.

2. 42% of respondents state that they blame external accountants for the legal and/or ethical problems facing Corporate America today.

[37] Gallup Poll, *Honesty/Ethics in Professions*, December 2015. Accountants were not included in the list of professions in the 2016 Gallup Poll.

3. Only 13% of respondents believe that accountants have become more ethical in the past five years.

4. 62% of respondents think that a professional accounting firm would look the other way if a client violated the law in order to maintain its relationship with the client.

5. 71% of respondents believe that if an accountant is hired by a company to review financial statements, but not retained to do an audit, they would expect the accountant to uncover fraud.

6. 67% believe a professional accounting firm that does not catch a company's fraud, should pay a severe penalty.

Although the survey is based on the public's perception of auditors, the conclusions reached apply to all accountants including those engaged in compilation and review engagements. Simply put, there continues to be evidence that the public does not differentiate between the accountant's responsibility related to an audit, review and a compilation engagement.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. According to the AICPA's Private Companies Practice Section (PCPS) of the Top Ten CPA Firm Issues published, which continues to be the biggest challenge for the accounting profession:
   a. Finding, hiring and retaining staff
   b. Work/life balance
   c. Keeping up with technology
   d. Client collections

2. Which of the following suggestions does the author provide to decrease audit time:
   a. Increase audit work in high-risk areas
   b. Replace analytical procedures with tests of account balances in low risk audit areas
   c. Set high materiality thresholds
   d. Use "canned" programs

3. To save time when auditing the accounts payable, which of the following procedures is recommended by the author:
   a. Do not request cut-off statements
   b. Eliminate confirmation of trade payables
   c. Performance of confirmation of receivables at interim to compare with payables
   d. Performance of physical observation at interim to assist with payables

4. Under AU-C Section 505, *External Confirmations* (formerly SAS No. 67), which is a factor that would indicate that confirmations should not be used with respect to accounts receivable:
   a. There is a large number of small account balances
   b. Audit risk is assessed very high
   c. The balance is immaterial
   d. The auditor believes recipients will reply

5. Which one of the following is required to be obtained as part of an audit:
   a. Engagement letter
   b. Legal letters for unasserted litigation, claims, and assessments
   c. The use of return envelopes in confirmations
   d. Verification of endorsements on the back of canceled checks

6. Elisa is a CPA. She is asked to submit certain financial information to a bank on behalf of a client. Which of the following is correct:
   a. She should send the information directly to the bank

b. She should send the information to the client who can send it to the bank
c. She should not send information at all
d. If she sends the information, she should give an opinion on that information

7. If supplying a comfort letter to a lender for a client, which of the following would be acceptable information for an accountant to supply to the lender:
   a. A statement giving assurance as to the accuracy of the information supplied
   b. A statement verifying the client's income
   c. A statement reiterating income that is listed on the client's tax return
   d. A statement that a down payment will not render the client insolvent

8. Ralph Ralston is a CPA performing an audit. On his audit report, which of the following is correct:
   a. Ralph's full address and telephone number must be included on the report
   b. Ralph must list the city and state on the report
   c. Ralph is not required to include his city and state on his report
   d. Ralph must include his telephone number but not his address on his report

9. Which of the following is correct based on the perception of accountants versus other professions:
   a. Accountants favorability rating is greater than nurses
   b. Accountants favorability rating is higher than lawyers
   c. Accountants favorability rating is lower than bankers
   d. Accountants favorability rating is lower than car salesmen

10. Based on a Camico study, which of the following is correct. More than 50 percent of respondents believe that _____.
    a. Accountants are not responsible for making sure their clients stay honest
    b. An accounting firm should have to pay a penalty if it does not catch a fraud
    c. Accountants have become more ethical in the past five years
    d. An accounting firm would not look the other way if a client violated the law

SUGGESTED SOLUTIONS

1. According to the AICPA's Private Companies Practice Section (PCPS), of the Top Ten CPA Firm Issues published, which continues to be the biggest challenge for the accounting profession:
   a. Correct. According to the AICPA's PCPS, finding, hiring and retaining staff continues to be the biggest challenge for the accounting profession.
   b. Incorrect. Work/life balance, although on the Top Ten list, is not one of the top issues. In fact, it is tenth on the list.
   c. Incorrect. Keeping up with technology is not at the top of the list. It is ninth on the list.
   d. Incorrect. Client collections is only number seven on the list.

2. Which of the following suggestions does the author provide to decrease audit time:
   a. Correct. The author suggests that auditors increase audit work in high-risk areas such as inventories and receivables to decrease audit time.
   b. Incorrect. The author suggests that auditors replace tests of account balances with analytical procedures in low risk audit areas to decrease audit time.
   c. Incorrect. The author suggests that auditors reassess the materiality threshold at a higher level established for the audit. Many firms set materiality too low and do too much work based on the assessment.
   d. Incorrect. The author suggests that auditors streamline the audit program and not use "canned" programs which include too many procedures.

3. To save time when auditing the accounts payable, which of the following procedures is recommended by the author:
   a. Incorrect. To save time when auditing the *cash*, auditors should not request cut-off statements. This procedure has no impact on accounts payable.
   b. Correct. To save time when auditing accounts payable, auditors should eliminate confirmation of trade payables. Confirmation usually does not test for unrecorded liabilities which is where the greatest audit risk lies.
   c. Incorrect. To save time when auditing the accounts receivable, the confirmation of receivables should be performed at interim. However, this procedure does not impact accounts payable.
   d. Incorrect. To save time when auditing *inventories*, the physical observation should be performed at interim. Even though inventories and accounts payable are related accounts, the physical observation at interim does not save time in auditing accounts

4. Under AU-C Section 505, *External Confirmations* (formerly SAS No. 67), which is a factor that would indicate that confirmations should not be used with respect to accounts receivable:
   a. Incorrect. Having a large number of small account balances is a factor to determine whether negative confirmations should be used but not a factor to determine whether overall confirmations should be used.
   b. Incorrect. If audit risk is assessed very low, confirmations may not be warranted.
   c. Correct. If the accounts receivable balance is immaterial, use of confirmations may not be warranted.
   d. Incorrect. If the auditor believes recipients will not reply, confirmations may not be useful.

5. Which one of the following is required to be obtained as part of an audit:
   a. Correct. Auditors must ensure that the client understands the nature and terms of the engagement in writing. Thus, an engagement letter is required. Previously, there was no requirement that such an understanding be in writing.
   b. Incorrect. Legal letters are not required for unasserted litigation, claims, and assessments. Letters of inquiry must be sent only to attorneys with whom management had consulted regarding litigation, claims and assessments.
   c. Incorrect. GAAS does not require the use of return envelopes for confirmations. However, in practice, most auditors use return envelopes to facilitate responses.
   d. Incorrect. Verifying endorsements on the back of canceled checks is not a required auditing procedure. Yet, an auditor may decide that this procedure is necessary given his or her assessment of inherent and control risk.

6. Elisa is a CPA. She is asked to submit certain financial information to a bank on behalf of a client. Which of the following is correct:
   a. Incorrect. By sending the information directly to the bank, there is a concern that the accountant could be creating a nexus between the lender and the accountant.
   b. Correct. By sending information to the client, Elisa avoids any suggestion that there is a nexus between the bank and the accountant.
   c. Incorrect. There is nothing to preclude the accountant from sending information that the bank might need.
   d. Incorrect. There is no requirement to give an opinion on that sent information, making the answer incorrect.

7. If supplying a comfort letter to a lender for a client, which of the following would be acceptable information for an accountant to supply to the lender:
   a. Incorrect. The accountant should refrain from issuing any statement giving any form of assurance as to the accuracy of the information supplied.
   b. Incorrect. The accountant should not verify the client's income as to do so may be tantamount to guaranteeing the accuracy of the information.
   c. Correct. Reiterating the amount of income that is listed on the client's tax return is usually acceptable language because it is not guaranteeing the accuracy of the information supplied.
   d. Incorrect. An accountant should not make any statement that a down payment will not render the client insolvent. To do so, may be construed as some form of assurance being made by the accountant.

8. Ralph Ralston is a CPA performing an audit. On his audit report, which of the following is correct:
   a. Incorrect. Only Ralph's city and state must be included on the report, not the full address and not the telephone number.
   b. Correct. Only the city and state must be included on the report.
   c. Incorrect. City and state must be included on the report.
   d. Incorrect. Ralph's telephone number does not have to be included on the report.

9. Which of the following is correct based on the perception of accountants versus other professions:
   a. Incorrect. Nurses have a higher rating of 80% versus accountants at 43%.
   b. Correct. Accountants are rated 43% versus lawyers at 21%.
   c. Incorrect. Bankers are rated 23% versus accountants at 43%.
   d. Incorrect. Car salesmen are rated at 8% while accountants are at 43%.

10. Based on a Camico study, which of the following is true. More than 50 percent of respondents believe that _____.
   a. Incorrect. 61% of those surveyed concluded that accountants are responsible for making sure their clients stay honest, making the answer incorrect.
   b. Correct. 67% concluded that an accounting firm should have to pay a severe penalty if it does not catch a fraud.
   c. Incorrect. Only 13% believe that accountants have become more ethical in the past five years, making the answer incorrect.
   d. Incorrect. 62% stated that an accounting firm would look the other way if a client violated the law, making the answer incorrect.

XVII. Communicating Internal Control Related Matters Identified in an Audit AU-C 265

Is an auditor of a small business required to send a written communication of deficiencies in internal control to the client under AU-C 265?

There appears to be confusion in practice as to when and how an auditor should communicate deficiencies of internal control. Some auditors automatically issue an internal control letter to the client while others do nothing.

What are the rules?

AU-C 265 replaces and expands upon the rules previously found in SAS. 115, *Communicating Internal Control Related Matters Identified in an Audit.*

AU-C 265 adds *two new requirements* that were not previously included in SAS No. 115:

a. The auditor is now required to communicate, in writing or orally, only to management, other deficiencies (that are not material weaknesses or significant deficiencies) in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

b. If there is a written communication identifying significant deficiencies or material weaknesses, the auditor must now include an explanation of the potential effects of those significant deficiencies and material weaknesses identified

Comparison of Old Versus New GAAS		
AU-C 265 requirements	**Previous SAS No. 115**	**NEW AU-C 265?**
The new SAS makes *explicit* the following requirements that have been implied in SAS No. 115. • The requirement to determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.	Previous GAAS under SAS No. 115 requires the auditor to *implicitly*: • Evaluate each deficiency in internal control identified during the audit to determine whether they are significant deficiencies or material weaknesses.	**Now explicit instead of implicit**

The auditor is required to communicate in writing to those charged with governance *significant deficiencies* and *material weaknesses* identified during the audit.	The auditor is required to communicate in writing to those charged with governance *significant deficiencies* and *material weaknesses* identified during the audit.	**NC**
New SAS adds *two new requirements* that are not required in SAS No. 115: 1. The requirement to communicate, in *writing or orally*, only to management, *other deficiencies* (that are not significant deficiencies or material weaknesses) in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. 2. The requirement to include in the written communication an explanation of the potential effects of the significant deficiencies and material weaknesses identified.	1. Under SAS No. 115 the auditor is not required to communicate other deficiencies in internal control identified during the audit, although nothing precludes an auditor from communicating a) deficiencies other than those that are significant or material weaknesses, and b) matters the auditor believes to be of potential benefit to the entity. 2. There is no requirement to include in the written communication an explanation of the potential effects of the significant deficiencies and material weaknesses identified.	**NEW** **NEW**

Looking at the chart about, an auditor is required to send a written communication to those charged with governance if there is a:

- Significant deficiency or
- Material weakness in internal control

If there is a deficiency in internal control that does not rise to the level of being a significant deficiency or material weakness, the auditor is required to communicate it with management either orally or in writing.

Definitions

1. For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

Deficiency in internal control. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an Previous control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Material weakness. A deficiency, or a combination of deficiencies, in internal control, such that there is a *reasonable possibility* that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Significant deficiency. A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Considerations Specific to Smaller, Less Complex Entities

The issue as to whether a written communication is requires is based on whether a) there is a deficiency in internal control, and then b) whether that deficiency is a significant deficiency or a material weakness.

a. If there is a deficiency that is *not a significant deficiency or material weakness*, an oral or written communication with management is sufficient with such communication being documented in the workpapers.

b. If, instead, the deficiency *is a significant deficiency or material weakness*, the communication *must be in writing* and it must be addressed to those charged with governance (e.g., the board of directors, etc.).

Following are examples of circumstances where there may be deficiencies (Changes made by the new standards are noted in ***bold italic***):

Examples of Circumstances That *May Be Deficiencies*, Significant Deficiencies, or Material Weaknesses

The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses. (New items added by AU-C 265 are in ***bold italic*** type.)

Deficiencies in the Design of Controls
The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses related to the design of controls:

- Inadequate design of controls over the preparation of the financial statements being audited.

- Inadequate design of controls over a significant account or process.

- Inadequate documentation of the components of internal control.

- Insufficient control consciousness within the organization (for example, the tone at the top and the control environment).

- ***Evidence of ineffective aspects of the control environment, such as indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance.***

- ***Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.***

- ***Evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk).***

- Absent or inadequate segregation of duties within a significant account or process.

- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).

- Inadequate design of IT general and application controls that prevents the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.

- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles (GAAP), the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording the entity's financial transactions or preparing its financial statements.

- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.
- Absence of an internal process to report deficiencies in internal control to management on a timely basis.

- ***Absence of a risk assessment process within the entity when such a process would ordinarily be expected to have been established.***

Failures in the Operation of Controls
The following are examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses related to the operation of controls:

- Failure in the operation of effectively designed controls over a significant account or process (for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process).

- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements).

- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is evaluated as a significant deficiency or material weakness.

- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.

- Undue bias or lack of objectivity by those responsible for accounting decisions (for example, consistent understatement of expenses or overstatement of allowances at the direction of management).

- Misrepresentation by entity personnel to the auditor (an indicator of fraud).

- Management override of controls.

- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

- An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control.

  Example: If the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a non-negligible deviation rate because based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

2. <u>Existence of compensating controls</u>:

The above list does not categorize the examples into thresholds such as those that are deficiencies, significant deficiencies and those that are material weaknesses.

The list provides some challenges for auditors of smaller companies. The Auditing Standards Board has stated that deficiencies in internal control that rise to the level of being a material weakness may include:

a. Employees or management who lack the qualifications and training to fulfill their assigned functions, such as the inability of a bookkeeper or internal accountant to prepare financial statements under GAAP,

b. Failure to perform reconciliations of significant accounts on a timely basis, such as a receivable or payable subsidiary ledger not being reconciled to the general ledger account in a timely or accurate manner, and

c. Failure of controls designed to safeguard assets from loss, damage, or misappropriation.

Many, if not most, small businesses have weaknesses in their internal control that would require significant additional cost to rectify.

Examples include:

- A bookkeeper or internal accountant who does not have the expertise or competency to prepare GAAP (or OCBOA) financial statements and related notes,

- A bookkeeper who does not regularly reconcile subsidiary accounts (e.g., accounts receivable or accounts payable) to the general ledger,

- A poor segregation of duties in the accounting function that can only be rectified by hiring more accounting personnel at significant cost, and

- A weak safeguarding of assets such as not maintaining a perpetual inventory during the year or not using pre numbered inventory tags during a physical inventory.

For many small businesses, the shareholders-officers are not likely to spend the additional funds to correct the above-noted deficiencies by hiring more employees. Yet, if the risk of loss is high enough that it is reasonably possible that there could be a material misstatement to the financial statements, the auditor may have to consider any of the above deficiencies to be a material weakness that must be communicated.

There may be instances in which there is a deficiency, the risk of which is mitigated by the existence of compensating controls that, if effective, may limit the severity of the deficiency and prevent it from being a significant deficiency or a material weakness.

a. Although the auditor is not required to consider the effects of compensating controls, the auditor may consider the effects of compensating controls related to a deficiency in operation provided the auditor has tested the compensating controls for operating effectiveness as part of the financial statement audit. Compensating controls can limit the severity of the deficiency, but do not eliminate the deficiency itself.

Example: An auditor discovers that there is a poor segregation of duties within a small business accounting department so that the same person reconciles cash and writes out checks for payment to vendors. The auditor discovers that there is a compensating control in effect in that the sole shareholder-officer reviews all supporting documentation related to all checks, signs all checks personally, and receives all bank statements directly from the bank for his review prior to giving them to the accountant who reconciles the cash.

Conclusion: Although there is a deficiency in internal control in that there is a poor segregation of duties, the auditor may conclude that the compensating controls (the shareholder-officer's mitigating procedures) are enough to conclude that the deficiency does not rise to the level of being a significant deficiency or a material weakness. The compensating controls do not eliminate the fact that there is *still a deficiency* in internal control.

What if there are compensating controls that mitigate the risks from the deficiencies?

Such a deficiency as one noted in the previous example may not be elevated to a material weakness or significant deficiency if the auditor can identify and test a compensating control that mitigates the risk associated with the deficiency.

If an auditor can identify a compensating control that mitigates the risk of material misstatement from the deficiency, the auditor can test the effectiveness of the control, make sure it is working as expected, and conclude that the deficiency has not risen to the level of being a significant deficiency or material weakness. Thus, there is a deficiency but no written reporting required because it is not considered a significant deficiency or material weakness. However, under the new AU-C 265, an auditor is now required to communicate in writing or orally, "other deficiencies."

A material weakness relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent, or detect and correct a material misstatement of the financial statements.

Observation: The concepts underlying control activities in smaller entities may be similar to those in larger entities. However, the formality with which such controls operate will likely vary. Smaller entities may find that certain types of control activities are not necessary because of controls applied by management. By way of example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control activities.

Smaller entities also may have fewer employees, thereby limiting the extent to which segregation of duties is practicable. However, in a small, owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. Conversely, such increased management oversight also may increase the risk of management override of controls.

3. Communication of Other Deficiencies in Internal Control to Management

a. The SAS requires the auditor to communicate (either in writing or orally), other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of *sufficient importance to merit management's attention* (although they do not rise to the level of significant deficiencies or material misstatements).

b. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

c. If the auditor has communicated deficiencies in internal control, other than significant deficiencies or material weaknesses, to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor is not required to repeat the communication in the current period.

d. For other deficiencies in internal control (other than significant deficiencies and material weaknesses), the appropriate level of communication may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

   Note: Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies and material weaknesses, the appropriate level is likely to be the CEO or CFO (or equivalent) because these matters also are required to be communicated to those charged with governance. For other deficiencies, operational management may be more appropriate.

   Note: The auditor also is not required to repeat information about such deficiencies if the information has been previously communicated to management by other parties, such as internal auditors or regulators. However, the auditor may consider it appropriate to recommunicate these other deficiencies if there has been a change of management or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's judgment in the circumstances.

4. No Material Weakness Communications

a. An auditor is permitted (but not required) to issue a written communication stating that *no material weaknesses* were identified during the audit.

   1) The auditor *should not* issue a written communication stating that no significant deficiencies were identified during the audit.

Note: Management or those charged with governance may request a written communication indicating that no material weaknesses were identified during the audit. A written communication indicating that *no material weaknesses* were identified during the audit does not provide any assurance about the effectiveness of an entity's internal control over financial reporting. However, an auditor is not precluded from issuing such a communication, provided that the communication includes the matters required by paragraph 4(a), (c) and (d), above.

However, a written communication indicating that no significant deficiencies were identified during the audit is precluded because such a communication has the potential to be misunderstood or misused.

Exhibit A: Illustrative Written Communication – Material Weakness and/or Significant Deficiency in Internal Control

The following is an illustrative written communication that is required if there is a material weakness and/or significant deficiency in internal control.

To Management and [*identify the body or individuals charged with governance, such as the entity's Board of Directors*] of ABC Company

In planning and performing our audit of the financial statements of ABC Company (the "Company") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be [*material weaknesses* or *material weaknesses or significant deficiencies*] and therefore, [*material weaknesses* or *material weaknesses or significant deficiencies*] may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be [*material weaknesses* or *significant deficiencies* or *material weaknesses and significant deficiencies*].

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. [*We consider the following deficiencies in the Company's internal control to be material weaknesses:*]

[*Describe the material weaknesses that were identified and an <u>explanation of their potential effects</u>.*]
NEW
[*A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in the Company's internal control to be significant deficiencies:*]

[*Describe the significant deficiencies that were identified and an <u>explanation of their potential effects</u>.*]
NEW
[*If the auditor is communicating significant deficiencies and did not identify any material weaknesses, the auditor may state that none of the identified significant deficiencies are considered to be material weaknesses.*]

Insert any other deficiencies (1)

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any governmental*

authorities to which the auditor is required to report] and is not intended to be, and should not be, used by anyone other than these specified parties.

[*Auditor's Signature*]
[*Date*]

Exhibit B: Illustrative No Material Weakness Communication

The following is an illustrative written communication indicating that *no material weaknesses* were identified during the audit.

To Management and [*identify the body or individuals charged with governance, such as the entity's Board of Directors*] of ABC Company

In planning and performing our audit of the financial statements of ABC Company (the "Company") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses. Given these limitations, during our *audit we did not identify any deficiencies in internal control that we consider to be material weaknesses*. However, material weaknesses may exist that have not been identified.

[*If one or more significant deficiencies have been identified, the auditor may add the following: Our audit was also not designed to identify deficiencies in internal control that might be significant deficiencies. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We communicated the significant deficiencies identified during our audit in a separate communication dated [date]*.]

Insert any other deficiencies (1)

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any governmental authorities to which the auditor is required to report*] and is not intended to be, and should not be, used by anyone other than these specified parties.

[*Auditor's Signature*]
[*Date*]

(1): The SAS requires an auditor to communicate with management any *other deficiencies* that do not rise to the level of significant deficiencies or material weaknesses, if those other deficiencies are of "*sufficient importance to merit management's attention*."

The SAS permits such communication to be done *orally or in writing*. If in writing, the author believes the best way to make such a communication is to issue a "no material weaknesses" letter (Exhibit B above), and insert any other deficiencies in the letter.

XVIII. Watch Out for the DOL and Audits of Employee Benefit Plans

There is an epidemic brewing with respect to audits of employee benefit plans as part of the submission of a client's Form 5500.

The Department of Labor is on a mission to clean up audits of employee benefit plans. In doing so, the DOL is matching audit reports submitted with Form 5500s with the AICPA list of firms that have completed peer reviews. In situations in which a firm either has not passed a peer review or has had an engagement review instead of a system review, the audit firm shows up on an exception list.

The results can be painful:

- The client's Form 5500 can be disqualified thereby subject to significant failure to file penalties.

- The CPA firm can be tossed out of the AICPA and, in limited cases, brought in front of the state licensing board.

Federal law requires employee benefit plans with 100 or more participants to have an audit as part of their obligation to file its Form 5500.

As part of its responsibilities, the DOL performs periodic inspections of CPA firm audit workpapers for plan audits.

According to the National Association of Plan Advisors:

- More than 300 investigations resulting in $1.27 billion in fines were levied by the DOL.
- ERISA reports as many as 75 percent of 401(k) plans that it audits are out of compliance.

If a firm is going to perform an audit of an employee benefit plan, make sure the engagement is performed thoroughly because a sub-par engagement could be exposed during the DOL inspection process. The penalties and risks are simply not worth it.

What are some of the challenges found in employee benefit plan audits?

The AICPA published a document that lists the most common deficiencies found in benefit plan audits. Following is a summary:[38]

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[38] AICPA, *Most Frequent Violations of Professional Standards, Employee Benefit Plan Investigations*

a. Using a limited scope engagement report which did not qualify as a limited scope engagement

b. Missing information regarding:

- Participant data
- Benefit payments
- Investments
- Not obtaining a service auditor's report
- Inadequate documentation, particularly with respect to forfeitures
- Missing audit program
- Missing disclosures about:
  - Fair value disclosures particularly with Level 3 investments
  - Changes in accumulated plan benefits (defined benefit plans)
  - The method and significant actuarial assumptions used to determine the plans' benefit obligations (defined benefit plans)
  - Investments representing 5 percent or more of total net assets
  - Net change in fair value for each significant type of investment
  - Funding policy and method to determine participants' contributions

Observation: In 2013 and 2014, numerous CPA firms have been notified that they were selected from the DOL's exception list. Those excepted firms received a letter from the AICPA notifying them of the purported violation and that the firm would be suspended from the AICPA and reported to their state licensing board.

These letters have created unnecessary turmoil and stress for the receiving firm. Apparently, the DOL is putting pressure on the AICPA peer review program to ensure that auditors perform quality audits. The fear is that the DOL will take the monitoring effort away from the AICPA and perform the monitoring itself.

The moral of the story is that auditors of employee benefit plans should make sure they either perform quality audits or give the audits up to another firm. The risk of being marked for performing a sub-par plan audit is simply too high relative to the potential fees that can be generated.

Assessing the Quality of Employee Benefit Plan Audits- DOL Report

In May 2015, the Department of Labor issued a report entitled *Assessing the Quality of Employee Benefit Plan Audits.*

The purpose of the report was to summarize the results of an assessment of the quality of audit work performed on the financial statement audits of employee benefit plans under ERISA.

The assessment was performed by the Office of the Chief Accountant (OCA), Employee Benefits Security Administration (EBSA), and U.S. Department of Labor (DOL), and involved a selection

of 2011plan year audits using a sample of 400 plan audits from a target population of 81,162 Form 5500 filings.

Results of the report show the following:

a. Deficiencies:
   - 61% of the audits fully complied with professional auditing standards or had only minor deficiencies under professional standards.

   - 39% of the audits (nearly 4 out of 10) contained major deficiencies with respect to one or more relevant GAAS requirements which would lead to rejection of a Form 5500 filing.

b. There is a clear link between the number of employee benefit plan audits performed by a CPA and the quality of the audit work performed.
   - Firms who performed the fewest number of employee benefit plan audits annually had a 76% deficiency rate.

   - Firms performing the most plan audits had a deficiency rate of only 12%.

c. The accounting profession's peer review and practice monitoring efforts have not resulted in improved audit quality or improved identification of deficient audit engagements.
   - In 4 of the 6 audit strata, a substantial number of CPA firms received an acceptable peer review report, yet had deficiencies in the audit work that were reviewed.

   - Firms that were members of the AICPA Employee Benefit Plan Audit Quality Center tended to produce audits that have fewer audit deficiencies.

   - Most CPAs in the two smallest audit strata are not Employee Benefit Plan Audit Quality Center members.

   Note: Members of the AICPA's Employee Benefit Plan Audit Quality Center (EBPAQC) tend to have fewer audits containing multiple GAAS deficiencies. Additionally, non EBPAQC member firms tend to have a larger number of GAAS deficiencies, per audit engagement, than EBPAQC members

d. Audit areas that are unique to employee benefit plans such as contributions, benefit payments, participant data and party-in-interest/prohibited transactions, continue to lead the list of audit deficiencies.

e. CPAs failed to comply with professional standards either because they were not adequately informed about employee benefit plan audits, or failed to properly utilize the technical materials that were in their possession.

f. Audit partners in firms performing a greater number of plan audits tended to have a greater amount of employee benefit plan specific training. In a number of instances, however, even having the proper technical guidance did not ensure that a quality audit was performed.

g. The Practice Monitoring Peer Review process established by the AICPA and administered by sponsoring state CPA societies *does not appear to be an effective tool in identifying deficient plan audit work* and ensuring compliance with professional standards.

Note: Although selecting an employee benefit plan audit is a required part of the peer review process (where applicable), CPAs who performed deficient audits often received acceptable peer review reports.

Recommendations:

The report makes the following makes the following eleven recommendations.

Enforcement

1. Revise case targeting to focus on:

   a. CPA firms with *smaller employee benefit plan audit practices* that audit plans with large amounts of plan assets, and

   b. CPA firms in the 25-99 plan audit strata given their high deficiency rates and the amount of plan assets ($317.1 billion) and plan participants (9.3 million) at risk from deficient audits.

2. Work with the National Association of State Boards of Accountancy (NASBA) and the AICPA to improve the investigation and sanctioning process for those CPAs who perform significantly deficient audit work.

   a. Work with NASBA to get state boards of accountancy to accept the results of investigations performed by EBSA or the AICPA's Professional Ethics Division, in order to use those results in disciplining CPAs (at the state licensing board level).

3. Amend ERISA to make sure the *annual reporting civil penalties focus on the responsible party*.

   a. The Secretary of Labor would be authorized to assess all or part of the current annual reporting *civil penalty of up to $1,100 per day against the accountant engaged to do an ERISA plan audit if the plan's annual report is rejected* due to a deficient audit or because the accountant failed to meet the standards for qualification to perform an ERISA plan audit.

4. Work with the AICPA's Peer Review staff to:

   - Streamline the peer review process and make it more responsive in helping to improve

employee benefit plan audit quality.

- Ensure that CPAs who are required to undergo a peer review have in fact had an *acceptable peer review*.

- *Identify those CPAs* who have not received an acceptable peer review and *refer those practitioners to the applicable state licensing boards of accountancy*.

Regulatory/Legislative

5. Amend the ERISA definition of "*qualified public accountant*" to include *additional requirements and qualifications* necessary to ensure the quality of plan audits. The Secretary of Labor would be authorized to issue regulations concerning the qualification requirements.

6. Amend ERISA to *repeal the limited-scope audit exemption*.

   a. This exemption prevents accountants from rendering an opinion on the plans' financial statements for assets held in regulated entities such as financial institutions.

7. Amend ERISA to give the Secretary of Labor authority to establish accounting principles and audit standards that would protect the integrity of employee benefit plans and the benefit security of participants and beneficiaries.

8. Work with the NASBA to encourage state boards of accountancy to require specific licensing requirements for CPAs who perform employee benefit plan audits. This would include specific training and experience in the audits of employee benefit plans.

9. Continue and expand EBSA's outreach activities:

   a. Continue the Agency's work with plan administrator organizations (e.g. ASPPA), to explain the importance of hiring competent CPAs to plan administrators and other plan fiduciaries with hiring authority.

   b. Use information contained in the EFAST2 database to target correspondence to:

      i. plan administrators in the 1-2 and 3-5 plan strata, highlighting the high deficiency rate among plan auditors and providing information about how to select a qualified plan auditor, and

      ii. CPA firms in the 25-99 stratum, discussing the audit deficiencies found in the audit study and working with the firms to ensure that plan audits comply with professional standards.

10. *Communicate with each of the state boards of accountancy* (licensing boards) regarding the results of the study and the need to ensure that only competent CPAs are performing employee benefit plan audits.

11. Expand EBSA's outreach with individual state societies of CPAs who have a large number of plan audits performed by CPA firms in the 1-5 plan audit stratum. For those states that do not already do so, encourage them to create employee benefit plan audit training programs.

Observation: It is clear from the report that the Department of Labor is planning to increase its focus on ERISA plan audits and penalize those CPA firms that issue deficient audits. In particular, firms that perform only a few ERISA audits will be targeted. The stakes are likely to get higher with a proposal to penalize CPA firms up to $1,100 per day for deficient audits.

XIX. Why Do Individuals Cheat and Commit Fraud?

Why do individuals cheat and commit fraud?

This is a question that has perplexed investigations for years. Generally, most accountants and auditors focus on the substance of a fraud and ignore the psychology of the perpetrator. How is it that an individual, in a position of power who otherwise appears normal and honest, cheats by committing fraud?

Fraudsters are generally put into two categories:

1. *Perpetual fraudsters (cheaters)* who enjoy perpetrating the fraud, not getting caught, and receiving the "cheaters' high, and

2. *Isolated fraudsters*: Otherwise honest individuals that, due to circumstances, have become dishonest.

A recent study sheds light on the matter and addresses the issue of perpetual fraudsters. In 2013, a group, led by Nicole Ruedy, published *The Cheater's High: The Unexpected Affective Benefits of Unethical Behavior*.[39]

The authors of the study conducted six experiments on individuals, allowing them to cheat in certain situations, then evaluating how they felt after acting unethically.

The study addresses the psychology of unethical behavior and why individuals cheat. This study is important to accountants who, in general, are not trained to evaluate the individuals within an organization for the risk that they may commit fraud. Instead, accountants and auditors are taught to evaluate fraud risk from a technical analysis perspective, otherwise ignoring the individuals who may be able to perpetrate a fraud.

Here are some of the conclusions from the study:

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[39] *The Cheater's High: The Unexpected Affective Benefits of Unethical Behavior*, Nicole E. Reudy, University of Washington, Francesca Gino, Harvard University, et al, (2013).

1. One reason for cheating is because there are so many ways to *cheat anonymously* due to the Internet and other means that shield one's identity.

    a. Software piracy costs the world about $63 billion per year

    b. The gap between the actual and reported taxes per the IRS is about $345 billion.

    c. One way to reduce cheating is to remove the cheater's ability to hide behind his or her anonymity.

2. In general, there is a segment of cheaters who experience a thrill, self-satisfaction, and a sense of superiority referred to as the "cheater's high." These individuals are referred to as *perpetual cheaters or fraudsters*.

3. Perpetual Cheaters who should have actually felt badly after acting unethically, actually received a boost and actually happy from the unethical action, particularly if the cheating involves only that individual's over-performance, and not another individual.

Other points regarding cheaters:

1. Individuals are more likely to cheat in a dimly-lit room than in a well-lit room, because they believe there is a lower probability of being caught.

2. Individuals are more likely to cheat when there are more proceeds to go around to others and the individual's behavior will not adversely affect others.

3. Individuals are more likely to cheat when placed in a position of perceived power.

4. Individuals are more likely to cheat when they feel tired, either physically or mentally.

Note: This fact may explain why so many students cheat on their SAT scores which are held on Saturday morning when the students are tired.

Ways to reduce cheating include:

1. Make shifts in the environment that seem unrelated to honesty but trigger self-reflection to make people less likely to cheat:

    a. Expand signs of surveillance to watch potential perpetrators:

        - Install mock cameras in retail stores and offices
        - Hang mirrors or pictures with eyes to dissuade cheating
        - Install a poster of eyes about an honestly box for coffee or other contributions.

2. Have an honor code to remind individuals of ethical behavior.

The remorse factor

There are key differences between the two types of cheaters/fraudsters:

- *Perpetual cheater/fraudster*: A perpetual cheater or fraudster generally has no remorse, and enjoys the "hunt" and cheater's high.

- *Isolated cheater/fraudster*: The isolated fraudster or cheater, generally has remorse after the fraud or cheating, and does not have the "cheater's high."

The isolated fraudster is more susceptible to the conditions in fraud triangle:

The isolated fraudster and cheater does not receive the cheater's high and generally has post-cheating remorse. This individual is generally susceptible to the three conditions found in the fraud triangle.

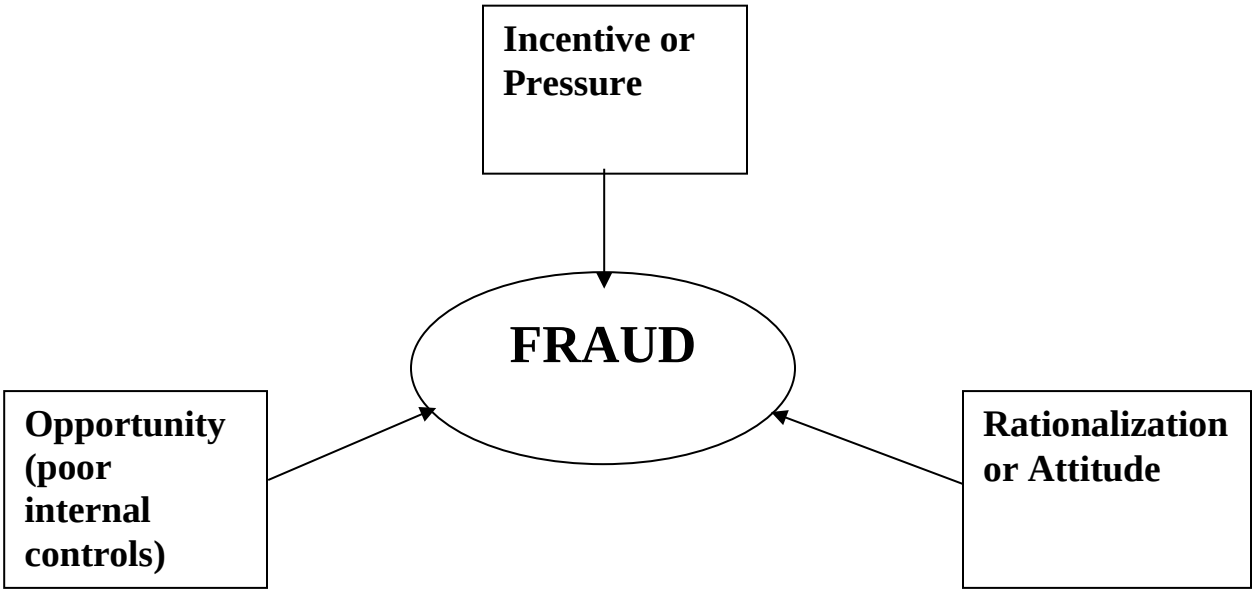
Let's look back at the t*hree conditions* of the fraud triangle that are usually present in a fraud:

Incentive or Pressure: Management or other employees have an incentive or are under pressure (financial or otherwise), which provides a reason to commit fraud.

Opportunity: Circumstances exist, such as the absence of controls, ineffective controls, or the ability of management to override controls, that provide an opportunity for a fraud to be perpetrated.

Rationalization or attitude: Individuals involved in the fraud are able to rationalize committing the fraud. Some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.

Fraud Triangle



- Has the incentive or pressure to commit the fraud
- Has rationalized the fraud and has the attitude to commit the fraud to obtain the "cheater's high."

All that is required is for the perpetual cheater/fraudster is to satisfy the third condition, which is to have an environment with *poor internal controls*. Then, it is off to the races.

For the isolated cheater/fraudster, none of the three conditions of the fraud triangle may have existed in the past. Yet, due to circumstances, this individual becomes a cheater/fraudster.

1. Incentive and pressure: Due to circumstances, the individual is under financial or other pressure, such as a divorce, living beyond his or her means, college education, etc.

2. Rationalization and attitude: The isolated cheater/fraudster justifies the cheating or fraud because the company has not given the individual a raise, or the person is overworked and underappreciated, or the company makes money and will not miss it, or that the person will pay the money back.

3. Poor internal controls: Once the first two conditions are met, all it takes is a poor internal control environment in order for an otherwise honest person to be converted to an isolated cheater/fraudster.

For the isolated cheater/fraudster, it all starts with incentive and pressure. If an isolated cheater/fraudster does not have the initial incentive and pressure to cheater or commit the fraud,

rarely does that individual perpetrate a fraud because that individual does not inherently want to cheat or commit a fraud.

Conversely, the perpetual cheater/fraudsters seeks to cheater or commit a fraud to feed the "cheater's high."

XX. Signing at the Beginning of a Document- Decreasing Dishonest Self Reports

Is a person more likely to be honest if he or she signs a document at the beginning rather than the end of that document?

There are numerous studies that address why individuals cheat.

One particular study , entitled, *Signing at the Beginning Makes Ethics Salient and Decreases Dishonest Self-Reports in comparison to Signing at the End*[42] *addresses how the location of a signature on a document can affect the degree of honesty of the signer.*

As an auditor or accountant, there are several documents that are received from clients including:

- Engagement letters
- Management representation letters

Such documents are important as they have representations on which the accountant or auditor relies.

There are other written forms that rely on honest reporting. Proof of honest intent is typically provided through signature at the end of tax returns or insurance policy forms.

In the study, the authors tested an easy-to-implement method to discourage dishonesty: *signing at the beginning rather than at the end of a self-report*. In doing so, the order of signing was reversed.

Conclusions from the study:

1. Signing at the beginning, rather than at the end, of the document: The opportunity to cheat makes ethics salient when they are needed most and significantly reduces dishonesty.

    a. The authors propose that a simple change of the signature location (to the beginning of the document) could lead to significant improvements in compliance and reduce fraudulent self-reporting.

2. Signing one's name *before reporting information* (rather than at the end) makes morality accessible right before it is most needed, which will consequently promote honest reporting.

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[42] *Signing at the Beginning Makes Ethics Salient and Decreases Dishonest Self-Reports in comparison to Signing at the End*, Lisa L. Shu, et al, July 2012.

a. Under current practice of signing after reporting information, the "damage" has already been done: immediately after lying, individuals quickly engage in various mental justifications, reinterpretations, and other "tricks" such as suppressing thoughts about their moral standards that allow them to maintain a positive self-image despite having lied.

b. Once an individual has lied, it is too late to direct their focus toward ethics through requiring a signature at the end of the document.

Observation: In court cases, witnesses verbally declare their pledge to honesty before giving their testimonies, not after, perhaps for a reason. To the extent that written reports feel more distant and make it easier to disengage internal moral control than verbal reports, written reports are likely to be more prone to dishonest conduct.

Results and Discussion

Experiment 1: In one experiment, the authors used two different measures of cheating:

- Self-reported earnings (income) on a math puzzle task wherein participants could cheat for financial gain, and

- Travel expenses claimed on a tax return form.

On the one-page form where participants reported their income and deductions, the authors varied whether participant signature was required at the top of the form or at the end. They also had a control condition wherein no signature was required on the form.

The authors measured the extent to which participants overstated their income from the math puzzles task and the amount of deductions they claimed.

Conclusion from experiment 1:

The percentage of participants who cheated by overstating income earned from math puzzles, and over claiming travel expenses on the tax return differed significantly across conditions:

37% cheated with the signature-at-the-top condition
79% cheated with the signature at the bottom and
64% cheated with no signature.

Second Experiment: Insurance Company Odometer Reading

The authors performed another experiment with an insurance company asking some of their existing customers to report their odometer reading. A higher odometer reading meant the customers paid a higher premium.

When a new policy is issued, each customer submits information about the exact current odometer mileage of all cars insured under their policy, along with other information.

The authors sent out automobile policy review forms to policyholders, randomly assigning them to either the original form used by the insurance company or to our redesigned form.

Original form: The original form asked customers to sign *at the bottom* of the statement:

> *"I promise that the information I am providing is true,"*

Redesigned form: The redesigned form asked customers to sign that same statement but *at the top of the form* (i.e., before filling it out; treatment condition).

Otherwise, the forms were identical.

Conclusion- experiment 2:

Asking customers to sign *at the top (beginning) of the form* led to a 10.25% increase in the calculated miles driven over the current practice of asking for a signature at the end. In other words, by signing at the beginning of a self-reporting document, a customer is more likely to be honest than by signing at the bottom of the form or not signing at all.

Using a field experiment, the authors demonstrated that a simple change in the location of a signature request can significantly influence the extent to which people on average will misreport information to advance their own self-interest.

Form **3305**

Center for Decision Research

Research Study Tax Return

For the period June 1, [illegible], through August 30, [illegible]

Keep a copy of this return for your records.

OMB No. 1555-0111

Sign Here

I declare that I carefully examined this return and that to the best of my knowledge and belief it is correct and complete.

▶ _____ Signature ▶ _____ Date

Write Clearly

Name

PID

Address (Number, street, and room or suite number)

City, State, and ZIP code

For Administrative Use Only

T .....
FF .....
FP .....
I .....
TL .....

Part 1 Please fill out the questions below to compute your taxed payment.

1. Please enter the payment you received on the problem solving task ($1 per correct matrix you solved in the other room) ▶	1	
2. Tax on payment: Please enter the equivalent of a 20% tax on your payment (i.e., 20 cents for every dollar earned ▶	2	
3. Please subtract the value specified in box 2 from value specified in box 1 ▶	3	

Part 2 Participants will be compensated for extra expenses they have incurred in order to participate in this study. In Part 2, you are asked to estimate the costs incurred in order to participate. These costs will be deducted from your tax return.

1. Please estimate the time it took you to come to the lab. You will be compensated $0.10 per minute, up to a 2 hour maximum ▶	4	
2. Please estimate the cost of your commute, if any, to come to the lab. You will be compensated up to a maximum of $12 ▶	5	
3. Please add the value specified in box 4 and the value specified in box 5 ▶	6	

Part 3 Please compute your final payment.

1. Please add the value specified in box 3 and the value specified in box 6. This is the amount of your final payment for today's session ▶	7	

Fig. S3. Tax form used in experiment 1, signature-at-the-top condition.

Form **3305**

Center for Decision Research

Research Study Tax Return

For the period June 1, [illegible] through August 30, [illegible]

Keep a copy of this return for your records.

OMB No. 1555-0111

Write Clearly

Name

PID

For Administrative Use Only

Address (Number, street, and room or suite number)

City, State, and ZIP code

T .....
FF .....
FP .....
I .....
TL .....

Part 1 Please fill out the questions below to compute your taxed payment.

a. Please enter the payment you received on the problem solving task ($2 per correct matrix you solved in the other room) ..... ▶	1	

Part 2 In Part 2, you are asked to estimate the costs incurred in order to participate. These costs will be deducted from your taxable income.

a. Please estimate the cost of the time it took you to come to the lab. You will be compensated $0.10 per minute, up to a 2 hour maximum (i.e., $12 maximum, computed as 120 min X $0.10 per min) ..... ▶	2	
b. Please estimate the cost of your commute, if any, to come to the lab. You will be compensated up to a maximum of $12 ..... ▶	3	
c. Please add the value specified in box 2 and the value specified in box 3 ..... ▶	4	

Part 3 Please compute your taxable income and your taxes.

a. Please subtract the value specified in box 4 from the value specified in box 1. This is the amount of your taxable income..... ▶	5	
b. Please compute your taxes by multiplying the value specified in box 5 by 50% ..... ▶	6	

Part 4 Please compute your final payment.

a. Please subtract the value specified in box 6 from the value specified in box 1. This is the amount of your final payment for today's session..... ▶	7	

Sign Here

I declare that I carefully examined this return and that to the best of my knowledge and belief it is correct and complete.

▶ _____ ▶ _____

Signature Date

Fig. S4. Tax form used in experiment 2, signature-at-the-bottom condition.

Form **3305**

Center for Decision Research

Research Study Tax Return

For the period June 1, [illegible], through August 30, [illegible]

Keep a copy of this return for your records.

OMB No. 1555-0111

Write Clearly

Name	PID	For Administrative Use Only
Address (Number, street, and room or suite number)		T .....
City, State, and ZIP code		FF .....
		FP .....
		I .....
		TL .....

Part 1 Please fill out the questions below to compute your taxed payment.

1. Please enter the payment you received on the problem solving task ($1 per correct matrix you solved in the other room) ..... ▶	1	
2. Tax on payment: Please enter the equivalent of a 20% tax on your payment (i.e., 20 cents for every dollar earned..... ▶	2	
3. Please subtract the value specified in box 2 from value specified in box 1 ..... ▶	3	

Part 2 Participants will be compensated for extra expenses they have incurred in order to participate in this study. In Part 2, you are asked to estimate the costs incurred in order to participate. These costs will be deducted from your tax return.

1. Please estimate the time it took you to come to the lab. You will be compensated $0.10 per minute, up to a 2 hour maximum ..... ▶	4	
2. Please estimate the cost of your commute, if any, to come to the lab. You will be compensated up to a maximum of $12 ..... ▶	5	
3. Please add the value specified in box 4 and the value specified in box 5 ..... ▶	6	

Part 3 Please compute your final payment.

1. Please add the value specified in box 3 and the value specified in box 6. This is the amount of your final payment for today's session..... ▶	7	

Fig. S2. Tax form used in experiment 1, no-signature (control) condition.

XXI. Auditing Standards Board (ASB) Agenda

Following is a list of projects that are pending with the Auditing Standards Board as of February 2017:

ASB Projects Status		
Project	**Objective**	**Status**
Proposed Statement on Auditing Standards, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.	This project would consider revisions to AU-C section 570 in response to FASB ASU on going concern and revised ISA 570	Exposure draft was issued. Final statement is expected in 2017.
Auditor's Reports: DOL and ERISA	This project addresses concerns raised by the Department of Labor (DOL) in its May 2015 report about the existing auditor's report for employee benefit plans. The ASB has been exploring alternative ways of reporting based on current performance standards for an EBP audit.	Exposure draft is expected in 2017
Sustainability Reporting	This project focuses on developing an attestation guide for engagements to provide assurance on sustainability-climate change reports	Guide is expected to be issued in 2017
Proposed Statement on Auditing Standards, Auditor Involvement With Exempt Offering Documents	This project would develop an auditing standard to address the criteria for auditor involvement in an exempt securities offering and the related auditor's responsibility when involved.	Exposure draft issued. Final statement is expected in 2017
Direct Engagements and Selected Procedures	This project would develop standards for attestation engagements that do not require a written assertion	Exposure draft is expected in 2017
Revision of ISA 720, The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements	This project would consider revision to AU-C section 720 to converge with revised ISA	Exposure draft is expected in 2017
Disclosures	This project would monitor the IAASB project and provide feedback to the IASTF and ASB; and to	Exposure draft is expected in 2017

	consider revisions to standards for convergence	
Estimates	This project would monitor the IAASB project and provide feedback to the IASTF and ASB; and to consider revisions to standards for convergence	Exposure draft is expected in 2017
Quality Control	This project's objective is to monitor the IAASB project and provide feedback to the IASTF and ASB; and to consider revisions to standards or guidance necessary in the short term.	Exposure draft is expected in 2017
Auditor's Reports—Dual reporting under GAAS and PCAOB standards	To discuss a possible amendment to AU-C 700 *Forming an Opinion and Reporting on Financial Statements*, to address the layout and wording of the auditor's report for audits conducted in accordance with *both* auditing standards generally accepted in the United States of America (GAAS) and another set of auditing standards, specifically the auditing standards of the Public Company Accounting Oversight Board (PCAOB).	Exposure draft is expected in 2017
	Source: Auditing Standards Board, as modified by the author.	

XXII. PCAOB and SEC Approve Naming Engagement Partners in Audit Engagements

Should the audit partner be named in the audit report of an SEC company?

In December 2015, the PCAOB approved a proposal that requires auditors to disclosure the names of each audit engagement partner and the names of other audit firms that participated in each audit.

Under the final rules, auditors are required to file a new PCAOB Form AP, *Auditor Reporting of Certain Audit Participants,* for each issuer audit, disclosing:

- The name of the engagement partner

- The names, locations, and extent of participation of other accounting firms that took part in the audit, if their work constituted 5 percent or more of the total audit hours, and

- The number and aggregate extent of participation of all other accounting firms that took part in the audit whose individual participation was less than 5 percent of the total audit hours.

The auditor is required to file the Form AP within 35 days (10 days for an initial public offering) after the date the auditor's report is first included in an SEC document.

Previously, the PCAOB had issued for public comment a re-proposed amendment to its auditing standards. The 2013 proposal was the second effort after a proposal that was issued in 2011. That 2013 proposal was once again superseded with a draft that became the final document approved in December 2015.

In May 2016, the SEC approved the new PCAOB rules. The disclosure requirement for the engagement partner will be effective for auditor's reports issued on or after January 31, 2017. For disclosure of other audit firms participating in the audit, the requirement is effective for reports issued on or after June 30, 2017.

XXIII. Auditor-Provided Tax Services

Does an auditor who does not perform non-attest tax services perform a better audit?

In 2005-2006, the PCAOB imposed restrictions on auditors' tax services to strengthen auditor independence and improve the quality of financial reporting. The restrictions resulted in a significant drop in auditor-provided tax services (APTS) particularly among the audit firms that had been accused of selling aggressive tax schemes.

PCAOB Rules 3521, 3522 and 3533, state that an SEC auditor is *not independent* of the audit client if the firm provides *any non-audit service* to the audit client related to marketing, planning or opining in favor of the tax treatment of:

- A confidential transaction engaged in only to avoid taxes

- Aggressive tax positions, that were initially recommended, directly or indirectly, by the firm

- Tax services for which the audit firm receives a commission or contingent fee based upon a particular finding in their tax evaluation.

In addition, audit firms are not permitted to provide tax services to individuals who have roles in the financial reporting with audit clients.

A recent study addresses the issue as to whether auditors who drop certain tax services, perform a higher quality audit.

The study[43] concludes the following:

1. Companies that significantly reduced their auditor-provided tax services do not exhibit a subsequent improvement in the quality of financial reporting.

2. Companies with the largest drops in auditor-provided tax services had the same degree of tax account misstatements before and after dropping the services, suggesting that there was no improvement in the tax accounts after dropping tax services.

3. Contrary to belief, investors welcome the practice of having the auditor perform tax services for the client because insight learned from providing tax services can enhance audit effectiveness and, in turn, the client's financial reporting quality.

Previously, there was another study performed that also addressed the issues of whether auditor provided tax services were beneficial to the investor. That earlier study[44] concluded:

1. On average, investors feel that the benefits of auditor-provided tax services outweigh the risks that the audit will not be performed independently enough,

2. The higher the ratio of tax fees to total fees paid to an auditor, the more pronounced the reduction in earnings per share if there is a shift in tax services away from the auditor.

3. Investors in companies that get tax services from their auditor *do not benefit* when a company splits up the tasks,

4. When the auditor function was decoupled from the tax-service function in companies, investors did not view that as a positive event.

5. There was a potential loss of knowledge spillover when tax services were provided by someone other than the auditor.

6. There is evidence that more company knowledge is shared between the tax and audit functions when one firm is used rather than more than one.

7. The spillover of knowledge that an auditor can receive from a tax professional working on the same company is an important advantage to companies and auditors alike. By doing the books and tax return, the accountant/auditor sees the whole picture.

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[43] *Tax Account Misstatements and the PCAOB's Restrictions on Auditor's Tax Services*, Clive S. Lennox, March 2015.

[44] *Do Auditor-Provided Tax Services Enhance or Impair the Value Relevance of Earnings?* American Accounting Association's Journal of American Taxation Association, Krishman, Visvanathan, and Wei Yu.

XX. ASB's Six-Point Plan to Improve Audits

The AICPA has issued its *Six-Point Plan to Improve Audits*, which the organization says is part of its effort to drive higher audit performance.

The plan concentrates on *financial statement audits for American private companies, employee benefit plans and governmental entities.*

According to the ASB, the plan has been created to promote the pursuit of audit quality throughout the CPA's career from the initial point before licensing to when he or she engages in peer review and practice monitoring.

The Six-Point Plan outlines enhancements in the following areas:

1. Pre-CPA Licensure: A next version of the CPA exam designed to increase assessment of higher-order skills, such as critical thinking and professional skepticism; high school Advanced Placement accounting course; changes to college-level accounting education; additional doctoral-level audit professors with practical experience.

2. Standards and Ethics: Quality control standards implementation support; auditor's report revisions; evaluation of clarified standards implementation; ethics code codification.

3. CPA Learning and Support: Competency models for audit engagements, including employee benefit plan and governmental audits; competency assessment tools; targeted resources to develop competencies; certificate programs to demonstrate competence.

4. Peer Review: Increased focus on greater risk industries and areas; more significant remediation; root cause analysis; termination from the peer review program after repeat quality issues.

5. Practice Monitoring of the Future: Long-term initiative for near real-time, ongoing monitoring of firm quality checks using robust technological platform.

6. Ethics Enforcement and NASBA Collaboration: More aggressive pursuit of reported deficiencies and stronger ties with the National Association of State Boards of Accountancy and state boards of accountancy.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. A _____ is defined as a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.
   a. Deficiency
   b. Material weakness
   c. Violation of internal control
   d. Weakness

2. Charlie Brown CPA is auditing Company Z. Charlie identifies a deficiency in internal control. What are his options with respect to this deficiency:
   a. Identify a compensating control
   b. Report it to the board of directors
   c. Ignore it unless it is a material weakness
   d. Make changes to strengthen the internal control

3. An auditor is required to communicate in writing to those charged with governance which of the following:
   a. Significant deficiencies
   b. Weaknesses
   c. Other deficiencies
   d. Important matters

4. Which of the following is an example of a deficiency in operation of controls:
   a. Inadequate documentation of the components of internal control
   b. Inadequate design of controls over a significant account or process
   c. Evidence of an ineffective response to identified significant risks
   d. Failure in the operation of effectively designed controls over a significant account or process

5. Which of the following is an example of a weakness in the internal control of a small business that would require a significant additional cost to rectify:
   a. A bookkeeper who does not regularly reconcile cash
   b. A stronger segregation of duties in the accounting function
   c. An internal CPA as a controller
   d. Not maintaining a perpetual inventory during the year

6. Which of the following is correct as it relates to a situation in which there are no significant deficiencies identified during an audit. The auditor_____stating that no significant deficiencies were identified during the audit.
   a. Should issue an oral or written communication
   b. Should not issue a written communication
   c. Is permitted to issue a written communication
   d. Is not permitted to issue an oral communication

7. Which of the following is a suggestion the author makes with respect to DOL audits:
   a. Make sure you charge enough because the work is tedious and high risk
   b. Make sure the engagement is performed thoroughly
   c. Do only a limited scope engagement
   d. Get out of the business

8. Which of the following is correct about a cheater:
   a. A cheater is less likely to cheat in a dimly-lit room
   b. A cheater is less likely to cheat when his or her behavior will not negatively affect other parties
   c. Cheaters are more likely to cheat when they are tired
   d. Cheaters are less likely to cheat when there is more money to go around to other parties

9. Company X is an insurance company and wants to ensure that its customers submit truthful claims forms. According to one study noted in the text, which of the following is a simple action that might help achieve a more truthful response:
   a. Have the customer sign at the end of the document
   b. Add language such as "I promise this is true"
   c. Include the signature at the beginning of the document
   d. Have the customer take a lie detector test

SUGGESTED SOLUTIONS

1. A _____ is defined as a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.
   a. Incorrect. A deficiency does not necessarily rise to creating a material misstatement, making the answer incorrect.
   b. Correct. A material weakness is a deficiency where it is reasonably possible that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.
   c. Incorrect. The definition presented is for a material weakness, and not for a violation of internal control. The term "violation of internal control" is not formally used within auditing standards.
   d. Incorrect. The definition is for a material weakness and not just a weakness, making the answer incorrect.

2. Charlie Brown CPA is auditing Company Z. Charlie identifies a deficiency in internal control. What are his options with respect to this deficiency:
   a. Correct. One solution is to identify a compensating control that keeps the deficiency from rising to the level of a significant deficiency or material weakness.
   b. Incorrect. Only a significant deficiency or material weakness must be reported to the board of directors, making the answer incorrect.
   c. Incorrect. If it is a significant deficiency or material weakness it must be reported in writing, making the answer incorrect.
   d. Incorrect. It is not the responsibility of the auditor to make changes to strengthen the entity's internal control

3. An auditor is required to communicate in writing to those charged with governance which of the following:
   a. Correct. An auditor must communicate in writing significant deficiencies and material weaknesses identified during the audit.
   b. Incorrect. Only material weaknesses must be communicated.
   c. Incorrect. An auditor must disclose other deficiencies to management and not those charged with governance. Further, such communications may be made orally, and not in writing.
   d. Incorrect. There is no requirement to communication important matters.

4. Which of the following is an example of a deficiency in operation of controls:
   a. Incorrect. Inadequate documentation of the components of internal control is an example of a deficiency in the design of controls, not a deficiency in operation of controls.
   b. Incorrect. Inadequate design of controls over a significant account or process is an example of a deficiency in the design of controls, not a deficiency in operation of controls.
   c. Incorrect. Evidence of an ineffective response to identified significant risks is an example of a deficiency in the design of controls, not a deficiency in operation of controls.
   d. Correct. Failure in the operation of effectively designed controls over a significant account or process is listed as a deficiency in the design of controls within GAAS.

5. Which of the following is an example of a weakness in the internal control of a small business that would require a significant additional cost to rectify:
   a. Incorrect. An example is a bookkeeper who does not regularly reconcile subsidiary accounts for accounts receivable or accounts payable to the general ledger, not the failure to reconcile cash.
   b. Incorrect. An example is a poor, not strong segregation of duties in the accounting function, making the answer incorrect.
   c. Incorrect. Having an internal CPA as a controller is not an example of a weakness in internal control that would require significant additional cost to rectify.
   d. Correct. One example is a weak safeguarding of assets such as not maintaining a perpetual inventory during the year.

6. Which of the following is correct as it relates to a situation in which there are no significant deficiencies identified during an audit. The auditor_____ stating that no significant deficiencies were identified during the audit.
   a. Incorrect. The SAS does not state that the auditor should issue an oral or written communication, making the answer incorrect.
   b. Correct. The SAS specifically precludes an auditor from issuing a written communication stating that no significant deficiencies were identified during the audit.
   c. Incorrect. The SAS does not permit issuing a written communication although a written communication is permitted with respect to a material weakness, but not a significant deficiency. Thus, the answer is incorrect.
   d. Incorrect. The SAS precludes an auditor from issuing of a written communication, but does not preclude an auditor from making an oral communication, making the answer incorrect.

7. Which of the following is a suggestion the author makes with respect to DOL audits:
   a. Incorrect. The author does not make this statement although charging enough is certainly implicit in any engagement
   b. Correct. The author notes that the DOL audits CPA firms regularly so that those firms should ensure that they perform their DOL audits thoroughly.
   c. Incorrect. Although a limited-scope engagement may be performed, there is no suggestion that it needs to be done.
   d. Incorrect. The author does not address whether an accountant should get out of the DOL audit business.

8. Which of the following is correct about a cheater:
   a. Incorrect. One study suggests that a person is more likely to cheat in a dimly-lit room rather than a well-lit room because it is less likely he or she will get caught.
   b. Incorrect. A study suggests that a person is more likely to cheat when his or her behavior will not negatively affect other parties. The reason is because the cheater does not feel as guilty for his or her action if no one is getting hurt by it.
   c. Correct. A study indicates that individuals cheat more often when they are tired either physically or mentally. That fact extends to a higher level of cheating by students who are tired from studying.

d. Incorrect. When there is more money to go around to other parties, a person is more likely to cheat according to one study. The reason is not explained in the study.

9. Company X is an insurance company and wants to ensure that its customers submit truthful claims forms. According to one study noted in the text, which of the following is a simple action that might help achieve a more truthful response:
   a. Incorrect. Signing at the beginning, not the end, might make the response more truthful according to one study, making the answer incorrect.
   b. Incorrect. Nothing in the study suggests that adding language such as "I promise this is true" makes the responses more truthful.
   c. Correct. The study suggests that if the signature is at the beginning of the document promotes more honest responses because the customer has to think about his or her honesty before completing it.
   d. Incorrect. The study does no address having the customer take a lie detector test. Moreover, such an action would not be a "simple" action and would be costly.

SECTION 3: Recent Auditing and Attestation Standards

XXV. SAS Nos. 128- 131

SAS No. 128: ***AU-C Section 610: Using the Work of Internal Auditors***

Issue Date: February 2014

Effective Date: This Statement on Auditing Standards is effective for audits of financial statements for periods ending on or after December 15, 2014.

Background:

Due to its Clarity Project, the Auditing Standards Board (ASB) has issued Statement on Auditing Standards (SAS) No. 128, *Using the Work of Internal Auditors*, to supersede SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, AU sec. 322 and AU-C sec. 610).

SAS No. 128 amends:

- SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, AU-C sec. 315);

- Various other sections in SAS No. 122 (AICPA, *Professional Standards*, AU-C secs. 200, 220, 230, 240, 260, 265, 300, 402, 500, 550, and 600); and

- Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control* (Redrafted) (AICPA, *Professional Standards*, QC sec. 10).

Rules:

SAS No. 128 addresses the external auditor's responsibilities if using the work of internal auditors.

Using the work of internal auditors includes:

a. using the work of the internal audit function in obtaining audit evidence and

b. using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor.

SAS No. 128 does not apply if the entity does not have an internal audit function.

If the entity has an internal audit function, the requirements in SAS No. 128 relating to using the work of the internal audit function in obtaining audit evidence do not apply if:

a. the responsibilities and activities of the function are not relevant to the audit, or

b. based on the external auditor's preliminary understanding of the function obtained as a result of procedures performed under AU-C section 315, the external auditor does not expect to use the work of the function in obtaining audit evidence.

SAS No. 128 does not require the external auditor to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor. It is the external auditor's decision to establish the overall audit strategy. Furthermore, the requirements in SAS No. 128 relating to using internal auditors to provide direct assistance do not apply if the external auditor does not plan to use internal auditors to provide direct assistance.

SAS No. 128 requires an external auditor to perform certain procedures with respect to an internal audit function:

1. Obtain an understanding of the entity's internal audit function (if such function exists). Describe the nature of the internal audit function's responsibilities, how the function fits in the organizational structure of the entity, and the activities performed (or to be performed) by the function.

2. If the *work* of internal auditors will be used to obtain audit evidence, the external auditor should perform the following procedures:

   a. Assess the competence and objectivity of the internal auditors.

   b. Determine if the internal audit function applies a systematic and disciplined approach to planning, performing, supervising, reviewing, and documenting its activities.

   c. Determine the nature and extent of the work of internal auditors that will be used in obtaining audit evidence and discuss the planned use of the work with the internal audit personnel to coordinate activities.

   d. Read internal audit reports related to the work that is planned to be used to understand the work and the related findings.

   e. Perform audit procedures on the internal auditors' work to evaluate that it was properly planned, performed, supervised, reviewed, and documented; sufficient appropriate evidence was obtained; conclusions reached are appropriate; and reports prepared by internal auditors are consistent with the results of the work. Re-perform some of the internal auditors' work that you intend to use as audit evidence.

   f. Before the conclusion of the audit, evaluate whether the conclusions reached above, concerning the internal audit function and the nature and extent of the use of its work, remain appropriate.

g. Document your evaluations and work performed.

3. If internal auditors are used to provide *direct assistance* under your direction, supervision, and review, perform the following procedures:

   a. Evaluate the existence and significance of threats to the objectivity of each of the internal auditors who will be providing direct assistance as well as any safeguards applied to reduce or eliminate the threats.

   b. Evaluate the competence of each of the internal auditors who will be providing direct assistance.

   c. Determine the nature and extent of the work that can be assigned to the internal auditors providing direct assistance.

   d. Direct, supervise and review the work performed by the internal auditors by performing the following:

      - Ensure that the nature, timing and extent of the work is responsive to the evaluations made in determining the work to be assigned to internal auditors.

      - Instruct the internal auditors to bring identified accounting and auditing issues to your attention.

      - As part of the review procedures, test some of the work performed by the internal auditors.

   e. Document your evaluations and work performed.

4. If the external auditor determines that the internal audit function lacks a systematic and disciplined approach, the auditor is not permitted to use the work of the internal auditor as audit evidence.

5. The external auditor should communicate with those charged with governance (or management) about the auditor's plans to use the internal audit function to provide direct assistance.

   a. The external auditor should obtain from those charged with governance (or management) a written acknowledgement confirming that the internal auditors will be permitted to follow the instructions of the external auditor and that the entity will not interfere with the work of the internal auditor.

SAS No. 129: *Amendment to Statement on Auditing Standards No. 122 Section 920,* Letters for Underwriters and Certain Other Requesting Parties*, as Amended*

Issue Date: July 2014

Effective Date: This Statement on Auditing Standards is effective for comfort letters issued on or after December 15, 2014. Early implementation is encouraged.

Background: SAS No. 129 addresses unintended changes to previous practice as a result of its Clarity Project. The ASB issued SAS No. 129, Amendment to Statement on Auditing Standards No. 122 Section 920, Letters for Underwriters and Certain Other Requesting Parties, as Amended.

AU-C section 920 addresses the auditor's responsibilities when engaged to issue letters (commonly referred to as comfort letters) to requesting parties in connection with a nonissuer entity's financial statements included in a registration statement or other securities offerings.

Rules:

The AU-C makes the following amendments to AU-C section 920:

- amends the requirement to inform the requesting party that the auditor cannot provide any assurance regarding the sufficiency of the procedures for the requesting party's purposes by changing "state in any discussion" to "communicate" so as to provide the auditor with more flexibility in making this required communication.

- clarifies that the requirement for the auditor to read the comfort letter issued by component auditors whose report is included in the securities offering applies to each component auditor, not only those comfort letters related to significant components.

- amends the requirement to attach the review report when the auditor states in the comfort letter that the auditor has performed a review of unaudited interim financial information to a requirement to attach the review report when the auditor states in the comfort letter that the auditor has issued a review report on unaudited interim financial information.
- amends application material to indicate that attaching the review report on unaudited interim financial information is required when the auditor states in the comfort letter that the auditor has issued a review report on unaudited interim financial information.
- amends example D to change the concluding paragraph from referring to the pro forma bases described in the notes to the pro forma financial statements to referring to the applicable accounting requirements of Rule 11-02 of Regulation S-X and renumbers example D as example D-1.
- adds a new example D-2 to address providing negative assurance on pro forma financial information as to compliance with pro forma bases as described in the pro forma financial information. amends example O to include wording to address procedures performed with regard to pro forma information and subsequent change period not previously carried forward from AU section 634, Letters for Underwriters and Certain Other Requesting Parties.
- makes additional editorial changes for clarity and consistency.

SAS No. 130: ***An Audit of Internal Control Over Financial Reporting That Integrates with an Audit of Financial Statements***

Issue Date: October 2015

Effective Date: This Statement on Auditing Standards is effective for integrated audits for *periods ending on or after December 15, 2016*.

Background:

The Auditing Standards Board (ASB) has issued this SAS No. 130 as a result of its working on a Clarity Project on the attestation standards found in the SSAEs.

Because engagements performed under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*,

and related attestation interpretation No. 1, *Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act et* al Standards, AT sec. 9501), are required to be integrated with an audit of financial statements, it is appropriate to move the content of AT section 501 from the attestation standards into generally accepted auditing standards (GAAS).

AT section 501 and the related attestation interpretation will be withdrawn when SAS No. 130 becomes effective.

When drafting SAS No. 130, the intention of the ASB was to adhere as closely as possible to AT section 501 and PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AICPA, PCAOB Standards and Related Rules, Auditing Standards), while aligning with GAAS and avoiding unintended consequences in practice.

SAS No. 130 also amends various sections in SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, in order to integrate the SAS into GAAS.

SAS No. 130 includes the following changes:

- The auditor is required to examine and report directly on the effectiveness of internal control over financial reporting. There is no longer an option to examine and report on management's assertion about the effectiveness of internal control over financial reporting.

- The term "significant account or disclosure" used in AT section 501 has been changed to "significant class of transactions, account balance, or disclosure" to align with terminology used in existing GAAS and clarify that the risk factors the auditor is required to evaluate in the identification of significant classes of transactions, account balances, and disclosures and their relevant assertions, are the same in the audit of internal control over financial reporting (ICFR) as in the audit of the financial statements.

- The SAS allows, as does AT section 501, the auditor to use the work of internal auditors and others in obtaining evidence about the effectiveness of internal control over financial reporting. Although AU-C section 610, *Using the Work of Internal Auditors*, does not discuss "others," the SAS requires the auditor planning to use the work of others in the audit of internal control over financial reporting to adapt and apply, as necessary, the requirements of AU-C section 610, including the need for others to apply a systematic and disciplined approach.

The objectives of the auditor in an audit of ICFR are to do the following:

- Obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment about the effectiveness of ICFR *(as of date).*

- Express an opinion on the effectiveness of ICFR in a written report, and communicate with management and those charged with governance as required by this SAS, base the auditor's findings.

Scope:

1. SAS No. 130 establishes requirements and provides guidance that applies only when an auditor is engaged to perform an audit of internal control over financial reporting (ICFR) that is integrated with an audit of financial statements.

Definitions:

SAS No. 130 offers the following definitions:

Audit of ICFR: An audit of the design and operating effectiveness of an entity's ICFR.

Control objective: The aim or purpose of specified controls. Control objectives address the risks that the controls are intended to mitigate. In the context of ICFR, a control objective generally relates to a relevant assertion for a significant class of transaction, account balance, or disclosure and addresses the risk that the controls will not provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented, or detected and corrected, on a timely basis.

Criteria: The benchmarks used to measure or evaluate the subject matter.

Detective control: A control that has the objective of detecting and correcting errors or fraud that have already occurred that could result in a misstatement of the financial statements.

Internal control over financial reporting (ICFR): A process effected by those charge with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with the applicable financial reporting framework and includes those policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the applicable financial reporting framework, and that receipts and expenditures of the entity being made only in accordance with authorizations of management and those charged with governance; and provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets could have a material effect on the financial statements.

Management's assessment about ICFR: Management's conclusion about the effectiveness of the entity's ICFR, based on suitable and available criteria.

Preventive control: A control that has the objective of preventing errors or fraud that could result in a misstatement of the financial statements.

Requirements of SAS No. 130:

1. An auditor of an audit of ICFR must do the following:

   Satisfy certain preconditions as follows:

   a. Obtain the agreement of management.

   b. Determine that the “as of” date corresponds to the balance sheet date (or period end date) of the period covered by the financial statements.

   c. The auditor should evaluate the effectiveness of the entity's ICFR using the same suitable and available criteria used by management for its assessment.

   Request a written assessment:

   a. The auditor should request from management a written assessment about the effectiveness of the entity's ICFR. Management's refusal to provide a written assessment represents a scope limitation.

   Integrate the audit of ICFR with the financial statement audit:

   a. Although the objectives of an audit of ICFR and an audit of financial statements are not the same, the auditor should plan and perform the integrated audit to achieve their respective objectives simultaneously.

      The auditor should design tests of controls:

      - To obtain sufficient appropriate audit evidence to support the auditor's opinion on ICFR as of the date specified in management's assessment about ICFR, and
      - To obtain sufficient appropriate audit evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

   b. If the auditor is engaged to audit the effectiveness of an entity's ICFR for a period of time, the requirements and guidance in SAS No. 130 should be modified accordingly, and the auditor should integrate the audit of ICFR with an audit of financial statements covering the same period of time.

   c. The auditor identifies a deficiency in ICFR, the auditor should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an acceptably low level.

   d. When concluding on the effectiveness of controls for the purpose of the financial statement audit, the auditor should evaluate the results of any additional tests of control performed by the auditor to achieve the objective related to expressing an opinion on the entity's ICFR.

2. Planning the ICFR audit

In planning the ICFR audit, the auditor should do the following:

a. The auditor should follow AU-C section 300, *Planning an Audit* and should establish an overall audit strategy that sets the scope, timing, and direction of the audit of ICFR that guides the development of the audit plan.

b. The auditor should focus more attention on areas of higher risk.

c. The auditor should evaluate whether the entity's controls sufficiently address identified risks of material misstatement due to fraud and the risk of management override of controls.

   Note: AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. If the auditor identifies deficiencies in controls designed to prevent, or detect and correct, misstatements caused by fraud during the audit of ICFR, the auditor should take into account those deficiencies when developing the response to risks of material misstatement. The auditor should use the same materiality for planning and performing the audit of ICFR and the financial statement audit.

3. Using the work of internal auditors or others

   a. The external auditor should obtain an understanding of the work of the internal audit function and others sufficient to identify those activities related to the effectiveness of ICFR that are relevant to planning and performing the audit of ICFR.

   b. The external auditor should evaluate the extent to which the external auditor will use the work of internal auditors or others to modify the nature or timing, or reduce the external audit procedures to be performed directly by the external auditor. When using the work of internal auditors, AU-C 610, *Using the Work of Internal Auditors* is applicable. When the external auditor plans to use the work of others in obtaining audit evidence or to provide direct assistance in the audit of ICFR, the external auditor should apply the requirements in AU-C 610 as if others were internal auditors.

4. Performing the ICFR audit

SAS No. 130 provides the following guidance for performing an ICFR audit:

   a. The auditor should use a *top-down approach* to the audit of ICFR to select the control test.

   b. The auditor should identify and test those entity-level controls that are important to the auditor's conclusion about whether the entity has effective ICFR.

   c. In an integrated audit, the auditor should evaluate the components of ICFR and deter whether:

- The components are present and functioning in the design, implementation, and operation of ICFR, and

- The components are operating together in an integrated manner to achieve the financial reporting objectives.

d. Because of its importance to financial reporting and to the integrated audit, the auditor should evaluate the period-end financial reporting process, which includes the following:

   1) Procedures used to enter transaction totals into the general ledger

   2) Procedures related to the selection and application of accounting policies

   3) Procedures used to record recurring and nonrecurring adjustments to the financial statements

   4) Procedures for preparing financial statements

e. As part of evaluating the period-end financial reporting process, the auditor should assess:

   - the inputs, procedures performed, and outputs of the processes the entity uses to produce its financial statements

   - the extent of IT involvement in the period-end financial reporting process
     who participates from management

   - the locations involved in the period-end financial reporting process

   - the types of adjusting and consolidating entries, and

   - the nature and extent of the oversight of the process by management and those charged with governance.

f. The auditor should identify significant classes of transactions, account balances, and disclosures, and their relevant assertions.

   Note: To identify significant classes of transaction: account balances, and disclosures, and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement items and disclosures.

   As part of identifying significant classes of transactions, account balances, and disclose and their relevant assertions, the auditor should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated.

g. When an entity has components, the auditor should identify significant classes of transactions, account balances, and disclosures, and their relevant assertions.

h. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should:

- understand the flow of transactions related to the relevant assertions, including whether these transactions are initiated, authorized, recorded, processed, and reported

- identify the points within the entity's processes at which a misstatement, including misstatement due to fraud, could arise that, individually or in combination with other misstatements, would be material (for example, points at which information is initially transferred, or otherwise modified)

- identify the controls that management has implemented to address these potential misstatements, and

- identify the controls that management has implemented over the prevention, or timing of detection and correction, of unauthorized acquisition, use, or disposition of the entity’s assets that could have a material effect on the financial statements.

Note: Because of the degree of judgment necessary, the auditor should either directly perform the procedures that achieve the requirements in paragraph (h) above, or supervise the work of internal auditors or others who provide direct assistance to the auditor.

The auditor should understand how IT affects the entity's flow of transactions and, as required by AU-C 315, *Understanding the Entity and Its Environment and Ass£ the Risks of Material Misstatement*, how the entity has responded to risks arising from IT.

i. The auditor should identify and test those controls that are important to the auditor's conclusion about whether the entity's controls sufficiently address the assessed risk of material misstatement to each relevant assertion.

5. Testing controls

a. The auditor should evaluate the design effectiveness of controls by determining whether the entity's controls, if operated as prescribed by persons possessing the necessary authority and competence to perform them effectively, satisfy the entity's control objectives, and can effectively prevent, or detect and correct, misstatements caused by errors or fraud that could result in material misstatements in the financial statements.

b. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

c. As the risk associated with the control being tested increases, the sufficiency and appropriateness of evidence that the auditor obtains should also increase.

d. The auditor should obtain evidence about the effectiveness of selected controls for each relevant assertion. The auditor is not responsible for obtaining sufficient appropriate evidence to support an opinion about the effectiveness of each individual control.

e. To obtain evidence about whether a selected control is effective, the auditor should test the control.

f. When the auditor identifies control deviations, the auditor should determine the effectiveness of the deviations on the auditor's assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

g. To express an opinion on ICFR as of a point in time, the auditor should obtain evidence that ICFR has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the entity's financial statements.

   Note: The auditor should balance performing the tests of controls closer to the as of date with the need to test controls over a sufficient period of time to obtain sufficient appropriate evidence of operating effectiveness.

h. When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, the auditor should determine what additional evidence concerning the operation of the controls for the remaining period is necessary.

i. The auditor should vary the nature, timing, and extent of testing of controls from period to period to introduce unpredictability into the testing and respond to changes in circumstances.

6. Identifying deficiencies in ICFR

a. The auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in ICFR.

b. For purposes of forming an opinion on the effectiveness of ICFR, the auditor should evaluate the severity of each deficiency in ICFR to determine whether the deficiency, individually or in combination, is a *material weakness* as of the date specified in management's assessment about ICFR. In performing such evaluation, the auditor should determine whether deficiencies that affect the same significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR, collectively result in a material weakness.

c. The auditor should evaluate the effect of compensating controls when determining whether a deficiency, or combination of deficiencies in ICFR is a material weakness at the date specified in management's assessment about ICFR.

Note: The auditor should test the operating effectiveness of such compensating controls to determine whether they operate at a level of precision that would prevent, or detect and correct, a material misstatement.

d. If the auditor initially determines that a deficiency, or a combination of deficiencies, in ICFR is not a material weakness, the auditor should consider whether a prudent official having knowledge of the same facts and circumstances, would likely reach the same conclusion.

e. The auditor should evaluate the severity of each deficiency in ICFR to determine whether the deficiency, individually or in combination, is a *significant deficiency*. In performing such an evaluation, the auditor should determine whether deficiencies that affect the significant class of transactions, account balance, or disclosure; relevant assertion; or component of ICFR collectively result in a significant deficiency.

7. Subsequent events

a. The auditor should inquire of management and, when appropriate, those charged with governance, about whether there were any changes in ICFR or conditions that might significantly affect ICFR subsequent to the as of date but before the date of the audit report. To obtain additional information about changes in ICFR or other conditions that might significantly affect the effectiveness of the entity's ICFR, the auditor should inquire about and read, for this subsequent period, the following:

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period
- Reports regarding deficiencies issued by other independent auditors
- Regulatory agency reports on the entity's ICFR, and
- Information about the effectiveness of the entity's ICFR obtained through other engagements performed for the entity by the auditor.

b. If, as a result of the subsequent events procedures, the auditor obtains knowledge about a material weakness that existed as of the date specified in management's assessment about ICFR, the auditor should issue an adverse opinion.

c. If the auditor obtains knowledge about conditions that did not exist at the as of date arose subsequent to that date and before the release of the auditor's report and such subsequent information has a material effect on the entity's ICFR, the auditor should include in the auditor's report an emphasis-of-matter paragraph directing the reader's attention to the subsequently discovered fact and its effects as disclosed in management’s report or an other-matter paragraph describing the subsequently discovered fact and effects.

Note: The auditor has no responsibility to keep informed of events subsequent to the date of auditor's report; however, the auditor should respond appropriately to facts that become known to the auditor after the date of the auditor's report that, had they been known to auditor at that date, may have caused the auditor to revise the auditor's report.

8. Concluding procedures

a. The auditor should form an opinion on the effectiveness of ICFR by evaluating evidence obtained from all sources, including:
   - The auditor's testing of controls for the ICFR audit
   - Any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements
   - Misstatements detected during the financial statement audit, and
   - Any identified deficiencies.

b. As part of evaluating evidence obtained from all sources, the auditor should review information issued during the year by the internal audit function (or similar functions) that address controls related to ICFR and evaluate deficiencies identified in those reports.

c. In addition to evaluating the findings from the auditor's testing of controls for the audit of ICFR, the auditor should evaluate the effect of the findings of the substantive procedures performed in the audit of financial statements on the effectiveness of ICFR. This evaluation should include, at a minimum:
   - The risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud
   - Findings with respect to noncompliance with laws and regulations
   - Findings with respect to related party transactions and complex or unusual transactions
   - Indications of management bias in making accounting estimates and selecting accounting principles, and
   - The nature and extent of misstatements detected by substantive procedures.

d. After forming an opinion on the effectiveness of the entity's ICFR, the auditor should evaluate management's report, which will accompany the auditor's report, to determine whether it contains the following:
   - A statement regarding management's responsibility for ICFR
   - A description of the subject matter of the audit (for example, controls over the preparation of the entity's financial statements in accordance with GAAP

- An identification of the criteria against which ICFR is measured
- Management's assessment about ICFR
- A description of the material weaknesses, if any, and
- The date as of which management's assessment about ICFR is made.

Note: If the auditor determines that any required element of management's report is income or improperly presented, the auditor should request management to revise its report.

9. Obtaining written representations

a. In an audit of ICFR, the auditor should obtain written representations from management:
   - acknowledging management's responsibility for establishing and maintaining effective ICFR
   - stating that management has performed an assessment of the effectiveness of the entity's ICFR and specifying the criteria
   - stating that management did not use the auditor's procedures performed during the integrated audit as part of the basis for management's assessment about ICFR
   - stating management's assessment about the effectiveness of the entity's ICFR base, the criteria as of a specified date
   - stating that management has disclosed to the auditor all deficiencies in the design operation of ICFR, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses
   - stating whether the significant deficiencies and material weaknesses identified and communicated to management and those charged with governance during previous engagements have been resolved and specifically identify any that have not, and
   - stating whether there were, subsequent to the date being reported on, any change in ICFR or other conditions that might significantly affect ICFR, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

b. If management does not provide the written representations required, the auditor should either withdraw from the engagement or disclaim an opinion on ICFR and consider the implications on the financial statement audit.

10. Communicating ICFR-related matters

a. The auditor should communicate in writing to management and those charged with governance *significant deficiencies* and *material weaknesses* identified during the integrated audit, including those that were remediated during the integrated audit and those that were previously communicated but have not yet been remediated.

b. If the auditor concludes that the oversight of the entity's financial reporting and ICFR by the audit committee (or similar subgroups with different names) is ineffective, the auditor should communicate that conclusion in writing to the board of directors or other sim governing body.

Note: The written communications referred to in paragraphs (a) and (b) above should be made by the report release date, which is the date the auditor grants the entity permission to use the auditor's report.

For a governmental entity, if such written communications would be publicly available prior to management's report on ICFR, the auditor is not required to make the written communications by the report release date. In that circumstance, the written communications should be made as soon as practicable, but *no later than 60 days* following the report release date.

c. The auditor should communicate in writing to management all deficiencies identified during the integrated audit on a timely basis, but *no later than 60 days* following the report release date, and inform those charged with governance when such a communication is made or is expected to be made.

Note: In making the written communication, the auditor is not required to communicate those deficiencies that are not material weaknesses or significant deficiencies that were included in previous written communications, regardless of whether those communications were made by the internal auditors, or others within the organization.

d. The auditor *should not issue a report* stating that no deficiencies were identified during the integrated audit. Also, because the auditor issues a report that expresses an opinion or effectiveness of the entity's ICFR, the auditor *should not issue a report* indicating that no material weaknesses were identified during the integrated audit.

11. Reporting on ICFR

a. The auditor's report on the audit of ICFR should be in writing and should include the following elements:

1) A title that includes the word *independent* to clearly indicate that it is the report of independent auditor

2) An addressee as required by the circumstances of the engagement

3) An introductory paragraph that includes the following:

- Identification of the entity whose ICFR has been audited
- A statement that the entity's ICFR has been audited
- Identification of the as of date
- Identification of the criteria against which ICFR is measured

4) A section with the heading "M*anagement's Responsibility for Internal Control Over Financial Reporting*"

5) A section with the heading "*Auditor's Responsibility*"

6) A section with the heading *"Opinion"* that includes the auditor's opinion on whet] the entity maintained, in all material respects, effective ICFR as of the specified date based on the criteria

7) The manual or printed signature of the auditor's firm

8) The city and state where the auditor practices, and

9) The date of the auditor's report.

b. If the auditor issues a separate report on ICFR, the auditor should add the following paragraph, in an other-matter paragraph with an appropriate heading, in accordance ' AU-C section 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report*, to the auditor's report the financial statements:

> *We also have audited, in accordance with auditing standards generally accepted in the United States of America, [entity name]'s internal control over financial reporting as of December 31, 20X8, based on [identify criteria] and our report dated [date of report which should be the same as the date of the report on the financial* statements] expressed thereon [include nature of opinion].

c. The auditor should date the report on ICFR *no earlier than* the date on which the auditor has obtained sufficient appropriate audit evidence to support the auditor's opinion, including evidence that the audit documentation has been reviewed.

Note: Because the audit on ICFR is integrated with the audit of the financial statements, when issuing separate reports on the entity's financial statements and on ICFR, the dates of the reports should be the same.

d. The auditor should modify the report on ICFR if any of the following conditions exist:

- One or more material weaknesses exist
- Elements of management's report are incomplete or improperly presented
- There is a limitation on the scope of the engagement
- The auditor decides to refer to the report of a component auditor, and

- There is other information contained in management's report.

e. If there are deficiencies that, individually or in combination, result in one or more material weaknesses as of the date specified in management's assessment about ICFR, the auditor should express an adverse opinion on the entity's ICFR, unless there is a limitation on scope of the engagement.

f. When ICFR is not effective because one or more material weaknesses exists, the auditor's report should include:

- The definition of a material weakness, and

- A statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in management's assessment about ICFR.

SAS No. 131: ***Amendment to Statement on Auditing Standards No. 122 Section 700, Forming an Opinion and Reporting on Financial Statements***

Issued Date: January 2016

Effective Date: This Statement on Auditing Standards is effective for audits of financial statements for periods *ending on or after June 15, 2016*. Application of the SAS before the effective date is not prohibited.

Background:

The objective of SAS No. 31 is to clarify the format of the auditor's report that should be issued when the auditor conducts an audit in accordance with PCAOB standards, but the audit is not under the jurisdiction of the PCAOB.

SAS No. 131 amends AU-C Section 700, *Forming an Opinion and Reporting on Financial Statements.*

SAS No. 122, AU-C 700, *Forming an Opinion and Reporting on Financial Statements,* addresses the auditor's responsibility to form an opinion on the financial statements. It also addresses the form and content of the auditor's report issued as a result of an audit of financial statements.

The Auditing Standards Board has issued SAS No. 131, *Amendment to Statement on Auditing Standards No. 122 Section 700,* Forming an Opinion and Reporting on Financial Statements (AICPA, *Professional Standards*, AU-C sec. 700), to clarify the format of the auditor's report that should be issued when the auditor conducts an audit in accordance with PCAOB auditing standards, but the audit is ***not*** under the jurisdiction of the PCAOB.

1. An audit *is under the jurisdiction of the PCAOB* if, to perform that audit, the auditor is required to be registered with the PCAOB and be subject to its inspection. In general, an audit is under

the PCAOB jurisdiction for certain entities, including issuers and non-issuer brokers and dealers registered with the SEC.

2. When the audit *is under the jurisdiction of the PCAOB*, the auditor must conduct the audit in accordance with the PCAOB standards, and the audit is **not** required to also be conducted in accordance with GAAS.

3. When the audit is ***not*** under the jurisdiction of the PCAOB but the entity desires, or is required by an agency, by a regulator, or by contractual agreement, to obtain an audit conducted under PCAOB standards, the auditor is required to ***also*** conduct the audit in accordance with GAAS.

SAS No. 131 deals with different reporting requirements of GAAS and PCAOB auditing standards. In situations in which the auditor refers to both the PCAOB standards and to GAAS in the auditor's report, SAS No. 131 requires the auditor to use the form of report required by the standards of the PCAOB, amended to state that the audit was also conducted in accordance with GAAS.

SAS No. 131 amends AU-C 700 and does the following:

a. Reminds auditors that when an auditor conducts an audit of financial statements in accordance with the standards of the PCAOB and the audit is not within the jurisdiction of the PCAOB, the auditor is required to also conduct the audit in accordance with generally accepted auditing standards (GAAS).

b. Addresses the different reporting requirements of GAAS and the auditing standards of the PCAOB by requiring, in the situation described in the previous text, that when the auditor refers to the standards of the PCAOB in addition to GAAS in the auditor's report, the auditor should use the form of report required by the standards of the PCAOB, amended to state that the audit was also conducted in accordance with GAAS.

c. Adds application material, including guidance relating to PCAOB reporting requirements for specific circumstances such as reporting on an integrated audit or supplementary information, and examples of circumstances in which dual reporting may arise for audits that are not within the jurisdiction of the PCAOB.

d. Adds Illustration 6, *"An Auditor's Report on Consolidated Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When the Audit Has Been Conducted in Accordance With Both Auditing Standards Generally Accepted in the United States of America and the Auditing Standards of the Public Company Accounting Oversight Board"* to the exhibit, "Illustrations of Auditor's Reports on Financial Statements."

Amendments- Auditor's Report for Audits Conducted in Accordance With the Standards of the PCAOB and GAAS When the Audit Is Not Within the Jurisdiction of the PCAOB:

1. When conducting an audit of financial statements in accordance with the standards of the PCAOB and the audit is *not within the jurisdiction of the PCAOB*, the auditor is required to also conduct the audit in accordance with GAAS.

    a. In such circumstances, when the auditor refers to the standards of the PCAOB in addition to GAAS in the auditor's report, the auditor should use the form of report required by the standards of the PCAOB, amended to state that the audit was also conducted in accordance with GAAS.

2. Auditors of financial statements of entities whose audits are within the jurisdiction of the PCAOB, which include issuers (as defined by the SEC) and nonissuer brokers and dealers registered with the SEC, are required to be registered with, and subject to inspection by, the PCAOB.

    a. In such circumstances, the AICPA Code of Professional Conduct requires AICPA members to conduct the audit in accordance with the standards of the PCAOB, and the audit is not required to also be conducted in accordance with GAAS.

3. When the auditor follows the standards of the PCAOB regarding the form of the auditor's report, PCAOB reporting requirements for specific circumstances, such as reporting on an integrated audit or supplementary information, may also be applicable.

4. The form of the auditor's report required by the standards of the PCAOB states that the audit was conducted in accordance with *"the standards of the Public Company Accounting Oversight Board (United States). "*

    a. A reference to *"the standards"* of the PCAOB indicates that the auditor has complied not only with the PCAOB's auditing standards, but also with the related professional practice standards of the PCAOB, including its independence rules; whereas a reference to "the auditing standards of the Public Company Accounting Oversight Board (United States)" is limited to compliance with the auditing standards of the PCAOB.

5. The auditor of financial statements of an entity whose audits are not within the jurisdiction of the PCAOB may, nevertheless, be responsible for complying with the independence and other related professional practice standards of the PCAOB if, for example, the engagement is subject to regulatory oversight that requires compliance with those rules.

    a. Whether the auditor conducts an audit of financial statements in accordance with the standards of the PCAOB or the auditing standards of the PCAOB depends on the circumstances of the engagement.

6. Examples of situations in which an auditor may be engaged to conduct an audit in accordance with the standards (or auditing standards) of the PCAOB for an entity whose audit is not within the jurisdiction of the PCAOB include:

    - Audits for clearing agencies and futures commission merchants registered with the U.S.

Commodities Futures Trading Commission (CFTC), as well as other entities registered with the CFTC

- Audits of financial statements included in certain securities offering documents pursuant to Regulation A of the Securities and Exchange Act of 1933; and

- Circumstances in which a nonissuer company desires, or is required by contractual agreement, to obtain an audit of its financial statements in accordance with the standards of the PCAOB.

7. This amendment is effective for *audits of financial statements for periods ending on or after June 15, 2016.*

Illustration 6, "An Auditor's Report on Consolidated Comparative Financial Statements Prepared in Accordance With Accounting Principles Generally Accepted in the United States of America When the Audit Has Been Conducted in Accordance With Both Auditing Standards Generally Accepted in the United States of America and the Auditing Standards of the Public Company Accounting Oversight Board"

Circumstances include the following:

- Audit of a complete set of general-purpose consolidated financial statements (comparative) of an entity whose audit is not within the jurisdiction of the PCAOB.

- The auditor has not been engaged to perform an audit of internal control over financial reporting that is integrated with an audit of the financial statements.

- The financial statements are prepared in accordance with accounting principles generally accepted in the United States of America

- The financial statements are audited in accordance with the auditing standards of the PCAOB and also auditing standards generally accepted in the United States of America (GAAS).

- The auditor refers to the auditing standards of the PCAOB in addition to GAAS in the auditor's report.

Independent Auditor's Report (1)

[Appropriate
Addressee]

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits **in accordance with the auditing (2) standards of the Public Company Accounting Oversight Board (United States) and 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 consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. (3)

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of X Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]
[City, State]
[Date]

Notes related to the audit report:

(1) A firm registered with the PCAOB may use the title *"Report of Independent Registered Public Accounting Firm."*

(2) When the audit is also conducted in accordance with the other professional practice standards of the PCAOB, omit the word "auditing."

(3) The last three sentences of this paragraph may be replaced with the following optional language to clarify that the audit performed did not require the level of testing and reporting on internal control over financial reporting required in an integrated audit.

> The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures

that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

XXII. SSAE No. 18: Attestation Standards: Clarification and Recodification

Issued: April 2016

Effective Date: Reports dated *on or after May 1, 2017.*

Objective: The objective of SSAE No. 18 is to redraft the Statements on Standards for Attestation Engagements (SSAEs) under the Auditing Standards Boards clarity project.

Background:

The attestation standards have been found in Statements on Standards for Attestation Engagements (SSAE) Nos. 10-17. Those standards have authorized accountants to perform certain non-traditional engagements including agreed-upon procedures engagements, forecasts and projections, and examinations or reviews of any subject matter.

During 2012 through 2015, the Auditing Standards Board (ASB) reissued most of auditing standards under its Clarity Project. The Accounting and Review Services Committee followed with its own Clarity Project for compilation and review standards with the issuance of SSARS No. 21. That left the SSAEs as the only major engagement type that had not been updated.

In April 2016, the ASB completed its own Clarity Project on the SSAES and issued SSAE No. 18, *Attestation Standards: Clarification and Recodification.* SSAE supersedes most of the previous SSAEs, and related interpretations, and is effective for reports dated on or after May 1, 2017.

The attestation standards establish requirements for performing and reporting *three types of engagements* on subject matter which is typically other than financial statements:

- Examination
- Review, and
- Agreed-upon procedures engagements**.**

Examples of subject matter other than financial statements that an accountant may report on using the SSAEs include:

- An entity's compliance with laws or regulations

- The effectiveness of an entity's controls over the security of a system, and
- The fairness of the presentation of a statement of greenhouse gas emissions.

The attestation standards are developed and issued in the form of SSAEs and are codified into sections. The identifier "AT-C" is used to differentiate the sections of the clarified attestation standards ("AT-C"
Sections) from the sections of the attestation standards that are superseded by SSAE No. 18 ("AT" sections).

The ASB used certain specific drafting conventions in issuing SSAE No. 18, to make the standards easier to read, understand, and apply:

- Establishing objectives for each AT-C section
- Including a definitions section, when relevant, in each AT-C section
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an Aprefix and presenting them in a separate section that follows the requirements section
- Using formatting techniques, such as bulleted lists, to enhance readability
- Including, when appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the AT-C section
- Including, when appropriate, special considerations relevant to examination, review, or agreed-upon procedures engagements for governmental entities within the text of the AT-C section

The attestation standards found in SSAE No. 18 *do not apply* to the following types of engagements:

- Audits under the SASs
- Compilations and reviews of financial statements under the SSARS
- Statements on Standards for Tax Services

SSAE No. 18 supersedes all existing attestation standards except for the following:

- SSAE No. 10, AT 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*- was reissued within auditing standards as SAS No. 130

- SSAE No. 10, AT 701, *Management's Discussion and Analysis*- was retained in its current form as new *AT-C 395, SSAE No. 18*

Following is a mapping of the existing SSAEs to the new SSAE No. 18:

CHANGES TO ATTESTATION STANDARDS BY SSAE NO. 18	
EXISTING SSAE	**EFFECT OF SSAE NO. 18**
SSAE No. 10, Attestation Standards: Revision and Recodification	Most of SSAE No. 10 replaced by SSAE No. 18. Exceptions: AT 501 is replaced by SAS No. 130 and AT 701 is retained.
SSAE No. 11: Attest Documentation	Replaced by SSAE No. 18
SSAE No. 12: Amendment to Statement on Standards for Attestation Standards No. 10, Attestation Standards: Revision and Recodification	Replaced by SSAE No. 18
SSAE No. 13: Defining Professional Requirements in Statements on Standards for Attestation Standards	Replaced by SSAE No. 18
SSAE No. 14: SSAE Hierarchy	Replaced by SSAE No. 18
SSAE No. 15: An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements	Replaced by SAS No. 130, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*.
SSAE No. 16: Reporting on Controls at a Service Organization	Replaced by SSAE No. 18
SSAE No. 17: Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence is Impaired	Replaced by SSAE No. 18

SSAE No. 18 replaces most, by not all, of the existing SSAEs, including most sections of SSAE No. 10, the primary SSAE. The following schedules present the mapping of existing SSAE sections with the new SSAE No. 18 sections.

MAPPING OF EXISTING SSAE SECTIONS WITH NEW SSAE 18 SECTIONS			
Existing SSAE 10-17 Sections		**New SSAE 18 Sections**	
SSAE/AT Section	Title	SSAE 18/AT-C Section	Title
SSAE 13- AT 20	Defining Professional Requirements in Statements on Standards for Attestation Engagements	AT-C 105	Concepts Common to All Attestation Engagements
SSAE 14- AT 50	SSAE Hierarchy	AT-C 105	Concepts Common to All Attestation Engagements
SSAE 10- AT 101	Attest Engagements	AT-C 105	Concepts Common to All Attestation Engagements
SSAE 11- AT 101	Attest Documentation	AT-C 205	Examination Engagements
SSAE 12- AT 101	Amendment to Statement on Standards for Attestation Standards No. 10, Attestation Standards: Revision and Recodification	AT-C 210	Review Engagements
SSAE 10- AT 201	Agreed-Upon Procedures Engagements	At-C 215	Agreed-Upon Procedures Engagements
SSAE 10- AT 301	Financial Forecasts and Projections	AT-C 305	Prospective Financial Information (1)
SSAE 17- AT 301	SSAE No. 17: Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence is Impaired		
SSAE 10- AT 401	Reporting on Pro Forma Financial Information	AT-C 310	Reporting on Pro Forma Financial Information
SSAE 10- AT 501	An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements	NA	Replaced by SAS No. 130, An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements
SSAE 10- AT 601	Compliance Attestation	AT-C 315	**Compliance Attestation**
SSAE 10- AT 701	Management's Discussion and Analysis	AT-C 395	**Management's Discussion and Analysis**
SSAE 16- AT 801	Reporting on Controls at a Service Organization	AT-C 320	**Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting**

(1) AT-C 305 no longer covers the compilation of prospective financial information which has been moved to AR-C 80, as part of SSARS No. 21 and 22.

New SSAE 18 Sections		
New SSAE 18 Section	**Title**	**Applies to**
AT-C 105	Concepts Common to All Attestation Engagements	Contains general requirements and application guidance applicable to any attestation engagement
AT-C 205	Examination Engagements	Provides guidance in performing an examination engagement on any non-financial statement subject matter or assertion.
AT-C 210	Review Engagements	Provides guidance for the performance of a review engagement on non-financial statement subject matter
At-C 215	Agreed-Upon Procedures Engagements	Contains guidance for performing an agreed-upon procedures engagement and issuance of a report of findings based on specific agreed-upon procedures to subject matter for use by specified parties.
AT-C 305	Prospective Financial Information	Provides guidance for the issuance of a forecast or projection report on prospective financial information
AT-C 310	Reporting on Pro Forma Financial Information	Contains guidance on the issuance of a report on pro forma financial information
AT-C 315	Compliance Attestation	Contains performance and reporting requirements and application guidance for performing either an examination or agreed-upon procedures engagement on an entity's compliance with specified requirements.
AT-C 395	Management's Discussion and Analysis	Offers guidance on reporting on MD&A.
AT-C 320	Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting	Contains performance and reporting requirements for reporting on an examination of controls at a service organization

Examples of Attestation Engagements

Following are examples of attestation engagements that are available to practitioners using the SSAE No. 18 standards:

Examination or Review of Anything other than financial statements:

- Compliance with agreements and loan covenants

- Internal control
- MD&A
- Controls of a service organization

Agreed-Upon Procedures Engagements: Customized procedures performed on anything including:

- Inventories, accounts receivable, payables
- Sales of a retail lessee and submitted to the lessor to compute rent overrides
- Break-even calculation on a business acquisition
- Business acquisition procedures on a company to be acquired by a client
- Procedures on a company that is in bankruptcy, on behalf of the creditors
- Calculation of square footage in a commercial building
- Compliance with specific laws, contracts, and grants such as: loan covenants and, lease agreements
- Investment performance of an investment or retirement fund
- Procedures performed on a recount of ballots cast in a Presidential election
- Ballots cast at the Academy Awards

Financial Forecasts and Projections:

- Performing financial forecasts and projections to obtain financing or raise capital
- Preparing a feasibility study

Other Engagements:

- Reporting on Pro Forma Financial Information

Preconditions for an Attestation Engagement

AT-C 105, *Concepts Common to All Attestation Engagements*, establishes certain preconditions that must be satisfies in order for an accountant to perform any attestation engagement. If these preconditions are met, an accountant is able to report on essentially any subject matter:

1. The practitioner (accountant) must be independent when performing all attestation engagements

    a. The exception to being independent is when a practitioner, regardless of independence, is required by law or regulation to accept the engagement and report on the subject matter or assertion.

2. The responsible party is a party other than the practitioner and takes responsibility for the subject matter.

3. The engagement exhibits all of the following characteristics:

    a. The subject matter is appropriate.

b. The criteria to be applied in the preparation and evaluation of the subject matter are suitable and will be available to the intended users.

c. The practitioner expects to be able to obtain the evidence needed to arrive at the practitioner's opinion, conclusion, or findings, including having access to information and unrestricted access to persons who have such information.

d. The practitioner's opinion, conclusion, or findings, in the form appropriate to the engagement, is to be contained in a written practitioner's report.

AT-C 105 provides the following definitions used throughout SSAE No. 18:

> **Responsible party.** The party(ies) responsible for the subject matter. If the nature of the subject matter is such that no such party exists, a party who has a reasonable basis for making a written assertion about the subject matter may be deemed to be the responsible party.
>
> **Specified party.** The intended user(s) to whom use of the written practitioner's report is limited.

Key Changes Made by SSAE No. 18

Most, by not all, of SSAE No. 18 consists of a carryover of information previously found in SSAE Nos. 10-17. However, SSAE No. 18 does make a few significant changes to the previous SSAEs as follows:

1. Requires a practitioner to obtain a written representation letter in all attestation engagements.

2. Requires a practitioner to obtain a written engagement letter or other suitable form of written agreement

3. In an examination engagement, requires a practitioner to obtain an understanding of the subject matter and other engagement circumstances sufficient to enable practitioners to perform a risk assessment of the subject matter.

4. Removes from the SSAEs, a compilation of prospective financial information engagement which is now contained as part of SSARS No. 21.

5. Changes the language found in the review report in AT-C 210 and examination report in AT-C 205.

6. For audits of service organizations, introduces a new requirement that a service organization must implement controls to monitor subservice organizations.

Removal of compilation of prospective financial information from SSAES

Prior to the issuance of SSAE No. 18, the guidance for reporting on prospective financial information (a forecast or projection) was found in SSAE No. 10 (AT section 301), *Financial Forecasts and Projections*. SSAE No. 10 permitted an accountant to perform a compilation, examination, or agreed-upon procedures engagement on prospective financial information.

With the issuance of SSAE No. 18, a compilation of prospective financial information engagement is officially removed from the SSAEs.

Now, with the issuance of SSARS No. 21, as amended by SSARS No. 23, the authority for an accountant to perform a compilation of prospective financial information (forecast or projection) engagement rests in SSARS No. 21 and not in the SSAE No. 18. Moreover, in new AR-C 70 of SSARS No. 21, a preparation of prospective information engagement is permitted.

The following table summarizes the authority for each type of engagement on prospective financial information:

Authority to Perform Engagement on Prospective Financial Information (1)	
Type of engagement	**Authority**
Preparation of prospective financial information	SSARS No. 21 (2)
Compilation of prospective financial information	SSARS No. 21 (2)
Examination of prospective financial information	SSAE No. 18
Agreed-upon procedures engagement on prospective financial information	SSAE No. 18
(1): Prospective financial information is either a forecast or a projection (2): As amended by SSARS No. 23	

The result is that an accountant who wishes to either prepare or compile prospective financial information follows the guidance found in SSARS No. 21, not SSAE No. 18. An accountant who wants to perform an examination or agreed-upon procedures engagement on prospective financial information follows the guidance found in SSAE No. 18. Details and guidance as to how to perform a preparation or compilation engagement on prospective financial information is found in the AICPA Guide on prospective financial information.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. In accordance with SAS No. 128, when does the internal audit function apply to an external audit:
   a. The external auditor does not plan to use the internal audit work to obtain audit evidence
   b. It applies always under the rules found in SAS No. 128
   c. If the external auditor expects to use internal auditors to provide direct assistance
   d. If the responsibilities of the internal audit function are no relevant to the audit

2. _____ is a control that has the objective of detecting and correcting errors or fraud:
   a. Preventive control
   b. Internal control
   c. Detective control
   d. ICFR

3. In planning an ICFR audit, an auditor should focus his or her work on areas of _____:
   a. Low risk
   b. High risk
   c. No risk as risk is not part of the ICFR audit assessment
   d. Concentrated risk

4. Jennifer Hudson is a CPA who is performing an integrated audit consisting of both an ICFR audit and an audit on financial statements. Which of the following should Jennifer communicate to management:
   a. Deficiencies in writing
   b. Material weaknesses either in writing or verbally
   c. The fact that no deficiencies were discovered
   d. Significant deficiencies in writing

5. Lindsey Lohan CPA has been asked by her client, Company X, to conduct an audit on X's financial statements. The audit is not within the jurisdiction of the PCAOB but must be conducted under the PCAOB standards. How should Lindsey conduct her audit:
   a. Lindsey must conduct the audit under GAAS only
   b. Lindsey must conduct the audit under PCAOB standards only
   c. Lindsey must conduct her audit under both GAAS and PCAOB standards
   d. Lindsey is precluded from performing the audit because the standards conflict

6. Kelly Ann CPA is determining which standards she should follow in performing certain engagements. Which of the following is an engagement for which she should follow the rules found in SSAE No. 18:
   a. Audit
   b. Compilation
   c. Tax service
   d. Examination

7. Big Lou CPA is performing an attestation engagement under SSAE No. 18. Which of the following parties is likely to be responsible for the subject matter in the attestation engagement:
   a. Big Lou, as the CPA, is the only one who can be responsible for the subject matter
   b. The specified party
   c. The bookkeeper
   d. A member of the board of directors or CEO

8. For the year ended December 31, 2017, Carol Franks CPA is asked by her client to perform a compilation of a financial forecast. Which rules should Carol following in performing this engagement:
   a. SSAE No. 18
   b. SSAE No. 10
   c. SSARS No. 21
   d. SAS No. 122

SUGGESTED SOLUTIONS

1. In accordance with SAS No. 128, when does the internal audit function apply to an external audit:
   a. Incorrect. The function does not apply if the external auditor does not plan to use the internal audit work to obtain audit evidence, making the answer incorrect.
   b. Incorrect. It does not apply always making the answer incorrect. SAS No. 128 states that it does not apply in certain instances.
   c. Correct. SAS No. 128 provides that the internal audit function is relevant to the external audit if the external auditor does, in fact, expect to use internal auditors to provide direct assistance.
   d. Incorrect. SAS No. 128 states that the function does not apply if the responsibilities of the internal audit function are not relevant to the audit. Thus, the answer is incorrect.

2. _____ is a control that has the objective of detecting and correcting errors or fraud:
   a. Incorrect. A preventive control is a control that has the objective of preventing errors or fraud, not detecting them, making the answer incorrect.
   b. Incorrect. An internal control does not have the objective of detecting fraud, but rather attempts to prevent fraud or errors, making the answer incorrect.
   c. Correct. A detection control's goal is to detect and correct errors or fraud that have already occurred that could result in a misstatement of the financial statements.
   d. ICFR is not a control the objective of which is detecting and correcting errors or fraud. Instead, it is a process designed to provide reasonable assurance regarding the preparation of reliable financial statements.

3. In planning an ICFR audit, an auditor should focus his or her work on areas of _____:
   a. Incorrect. SAS No. 130 requires an auditor to focus on risk. Focusing on low risk would make no sense as low risk areas would not have a material effect on financial statements.
   b. Correct. SAS No. 130 requires the auditor to focus in areas of high risk consistent with the overall audit model. Areas of high risk are likely to result in a material effect on financial statements.
   c. Incorrect. SAS No. 130 does provide risk as part of the ICFR audit assessment making the answer incorrect.
   d. Incorrect. The risk threshold in SAS No. 130 is high risk, not concentrated risk.

4. Jennifer Hudson is a CPA who is performing an integrated audit consisting of both an ICFR audit and an audit on financial statements. Which of the following should Jennifer communicate to management:
   a. Incorrect. Only significant deficiencies, and not just deficiencies, should be communicated.
   b. Incorrect. Although Jennifer must communicate material weaknesses, such communication must be in writing, with a verbal communication not being an option.
   c. Incorrect. SAS No. 130 states that an accountant should not communicate the fact that no deficiencies were discovered.

d. Correct. Jennifer must communicate significant deficiencies in writing making the answer correct.

5. Lindsey Lohan CPA has been asked by her client, Company X, to conduct an audit on X's financial statements. The audit is not within the jurisdiction of the PCAOB but must be conducted under the PCAOB standards. How should Lindsey conduct her audit:
   a. Incorrect. SAS No. 131 requires that the audit must also be conducted under GAAS, but not solely under GAAS.
   b. Incorrect. SAS No. 131 states that the audit must also be conducted under GAAS when the audit is not within the jurisdiction of the PBAOB, making the answer incorrect.
   c. Correct. When the audit is to be conducted under PCAOB standards, the audit must also be conducted under GAAS as required by SAS No. 131.
   d. Incorrect. SAS No. 131 does not state that Lindsey is precluded from performing the audit because the standards conflict. Thus, the answer is incorrect.

6. Kelly Ann CPA is determining which standards she should follow in performing certain engagements. Which of the following is an engagement for which she should follow the rules found in SSAE No. 18:
   a. Incorrect. SSAE No. 18 specifically states that its attestation standards do not apply to an audit under the SASs.
   b. Incorrect. SSAE No. 18 does not apply to engagements performed under the SSARSs such as a compilation engagement.
   c. SSAE No. 18's attestation standards do not apply to tax services covered under the Statements on Standards for Tax Services
   d. Correct. SSAE No. 18 applies to examination engagements related to any subject matter, making the answer correct.

7. Big Lou CPA is performing an attestation engagement under SSAE No. 18. Which of the following parties is likely to be responsible for the subject matter in the attestation engagement:
   a. Incorrect. The CPA is not responsible for the subject matter. Big Lou's sole role is to perform the engagement.
   b. Incorrect. The specified party is the intended user of the practitioner's report and is not necessarily the one who is responsible for the subject matter.
   c. Incorrect. The bookkeeper is not likely to be at a level of management to be responsible for the subject matter.
   d. Correct. The party who is responsible for the subject matter is called the responsible party. The responsible party is a party who has a reasonable basis for making a written assertion about the subject matter. That person would have to be at a high level in the company and therefore the CEO and/or board of directors member is likely to be at that level. Thus, the answer is correct.

8. For the year ended December 31, 2017, Carol Franks CPA is asked by her client to perform a compilation of a financial forecast. Which rules should Carol following in performing this engagement:
   a. Incorrect. SSAE No. 18 removes a compilation of prospective financial information engagement from its application effective for reports dated on or after May 1, 2017.

b. Incorrect. For reports dated on or after May 1, 2017, SSAE No. 10 is superseded by SSAE No. 18. Thus, SSAE No. 10 cannot be correct as the report is to be dated after May 1, 2017.

c. Correct. The guidance and authority for issuing a compilation of prospective financial information is found in SSARS No. 21 making the answer correct.

d. Incorrect. A compilation engagement is not an audit engagement so that the auditing guidance found in SAS No. 122 does not apply to a compilation engagement of any kind.

Glossary

Audit of ICFR: An audit of the design and operating effectiveness of an entity's ICFR.

Brainstorming: A method of shared problem solving in which all members of a group spontaneously contribute ideas.

Control objective: The aim or purpose of specified controls. Control objectives address the risks that the controls are intended to mitigate.

Criteria: The benchmarks used to measure or evaluate the subject matter.

Deficiency in internal control: The design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

Detective control: A control that has the objective of detecting and correcting errors or fraud that have already occurred that could result in a misstatement of the financial statements.

Emphasis-of-matter paragraph: A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Fraud: An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.

Group: All the components whose financial information is included in the group financial statements. A group always has more than one component.

Group engagement partner: The partner or other person in the firm who is responsible for the group audit engagement and its performance and for the auditor's report on the group financial statements that is issued on behalf of the firm.

Group engagement team: Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Group financial statements: Financial statements that include the financial information of more than one component.

Internal control over financial reporting (ICFR): A process effected by those charge with governance, management, and other personnel, designed to provide reasonable assurance

regarding the preparation of reliable financial statements in accordance with the applicable financial reporting framework.

Management's assessment about ICFR: Management's conclusion about the effectiveness of the entity's ICFR, based on suitable and available criteria.

Material weakness: A deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Modified opinion: A qualified opinion, an adverse opinion, or a disclaimer of opinion.

Money laundering: To move illegally acquired cash through financial systems so that it appears to be legally acquired.

Noncompliance: Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

Other-matter paragraph: A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

Pervasive: A term used in the context of misstatements to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit-evidence.

Preconditions for an audit: The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, when appropriate, those charged with governance, to the premise on which an audit is conducted.

Preventive control: A control that has the objective of preventing errors or fraud that could result in a misstatement of the financial statements.

Privity standard: Accountant's liability is limited to those third parties with whom the accountant has a contractual relationship.

Professional skepticism: An open-minded attitude that presumes that parties are neither totally honest nor totally dishonest.

Public Company Accounting Oversight Board (PCAOB): A regulatory body created by the Sarbanes-Oxley Act of 2002, which regulates audits of SEC registrants, and operates under the U.S. Securities and Exchange Commission.

Rainy day fund: A hidden reserve that can be used to adjust quarterly earnings.

Recurring audit: An audit engagement for an existing audit client for whom the auditor performed the preceding audit.

Responsible party: The party(ies) responsible for the subject matter. If the nature of the subject matter is such that no such party exists, a party who has a reasonable basis for making a written assertion about the subject matter may be deemed to be the responsible party.

Sarbanes-Oxley Act: The Act signed into law that became effective in 2002. The Act contains sweeping reforms for issuers of publicly traded securities, corporate board members, and lawyers. It adopts tough new provisions intended to deter and punish corporate and accounting fraud and corruption, threatening severe penalties for wrongdoers, and protecting the interests of workers and shareholders.

Significant component: A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

Significant deficiency: A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Special purpose financial statements: Financial statements prepared in accordance with a special purpose framework.

Special purpose framework: A financial reporting framework other than GAAP that is one of the following bases of accounting: cash basis, tax basis, regulatory basis, or contractual basis.

Specified party: The intended user(s) to whom use of the written practitioner's report is limited.

Spring-loading: The practice in which an entity acquiring another entity may try to manipulate the financial performance of the target entity during the pre-acquisition period.

Final Exam

1. AICPA's Top Technology Issues includes all of the following except:
   a. Securing the IT environment
   b. Ensuring privacy
   c. Preventing and responding to computer fraud
   d. 3G wireless

2. Section 404 of Sarbanes-Oxley Act requires that the company's auditor evaluate management's assessment of internal control by taking certain steps. One of those steps is to_____:
   a. Draft a memorandum on the company's internal control and distribute it to the company's management and board of directors
   b. Identify control deficiencies and categorize them into four separate categories
   c. Issue, if applicable, an unqualified opinion on the company's financial statements
   d. Perform a walkthrough of the company's significant processes

3. Which of the following is a change made by Dodd-Frank with respect to Section 404:
   a. Dodd-Frank specifically exempts all public companies from Section 404(a) only
   b. Dodd-Frank specifically exempts all public companies from Section 404(a) and (b)
   c. Dodd-Frank specifically exempts non-accelerated filers from having to comply with Section 404(b) only
   d. Dodd-Frank specifically exempts non-accelerated filers from having to comply with section 404(a) and (b)

4. According to a *Wall Street Journal* report, many of the advantages of staying public no longer exist. Reasons why an entity might not wish to stay public include all of the following *except*:
   a. Access to public market capital is no longer important
   b. Smaller public companies do not benefit from the public markets like the larger companies do
   c. The direct and indirect costs of staying public exceed the benefits
   d. In general, smaller companies do not reap the benefits of higher stock prices

5. According to one article noted in the course, board members need to do which one of the following:
   a. Perform their own independent audit
   b. Purchase sizeable D&O insurance policies to cover malpractice and negligence
   c. Ask hard questions of management
   d. Have legal counsel and strong asset protection techniques in place to protect against personal liability

6. Section 953 of Dodd-Frank requires disclosure of which of the following:
   a. The annual total compensation of the lowest one third of all employees of an issuer
   b. The annual total compensation of the CEO of an issuer
   c. The annual total compensation of all employees of an issuer
   d. The annual total compensation of the CEO and all senior management of an issuer

7. According to the *2016 Report to the Nation*, which of the following is a very effective control in detecting and limiting financial statement fraud schemes:
   a. Hire a controller with a strong financial background
   b. Granting rewards for whistleblowing
   c. Paying accounting personnel more higher than average compensation
   d. Performing an external audit

8. Under Section 806 of Sarbanes-Oxley, which of the following whistleblowing protections is provided for employees of public companies:
   a. Requires a company board to pay whistleblowers a referral fee
   b. Requires a company to rehire an employee at three times his or her previous average compensation over the past three years
   c. Prevents a company from discharging an employee for providing information about fraud
   d. Permits a company to sue an employee who whistleblows false information

9. An incentive for a whistleblower to overreact and report to the SEC prematurely is:
   a. The information provided to the SEC must be fresh
   b. The first party to disclose a fraud is the only one who receives the reward
   c. There is a short time limit to whistleblow and receive a reward
   d. The special anti-retaliation rules allow for a very short window of protection after which a company can retaliate against an employee without recourse

10. One incentive for a company to offer a mechanism for employees to report an SEC violation first to the company is:
    a. It allows a company to correct the action internally before being reported to the SEC
    b. It allows the company to terminate the employee before the employee is able to report to the SEC
    c. It allows a company to file an injunction against the employee before the employee is able to report to the SEC
    d. It allows the company to modify files and other evidence and develop a defense strategy before being reported to the SEC

11. With respect to recurring peer review comments, deficiencies in audit procedures noted include all of the following <u>except</u>:
    a. Failure to perform cash reconciliations
    b. Failure to use a written audit program
    c. Failure to obtain a client management representation letter
    d. Failure to tailor audit programs for specialized industries

12. Specific financial statement deficiencies noted in peer reviews related to assets include all of the following <u>except</u>:
    a. Investments in majority owned or controlled subsidiary not consolidated
    b. Cash overdrafts shown as a negative balance in the current asset section
    c. Inventories valued using the wrong accounting method
    d. Improper classifications between current and long-term assets

13. Specific financial statement deficiencies noted in peer reviews related to incomplete and missing disclosures include which of the following:
    a. Not disclosing the basis of accounting other than GAAP
    b. Not disclosing the amount of the fixed assets on hand
    c. Not parenthetically disclosing the allowance for bad debts
    d. Not disclosing the five-year minimum payments on notes receivable

14. Common functional area deficiencies noted in peer reviews related to employee benefit plans include which one of the following:
    a. Inadequate testing of investment income
    b. Failure to understand testing requirements on a full-scope engagement
    c. Failure to include the proper wording in the report
    d. Inadequate testing of participant data and investments

15. In accordance with the AICPA peer review program, which of the following types of engagements performed would require that a system review be performed on that firm: A firm that performs:
    a. Only compilations that omit substantially all disclosures
    b. Only audits
    c. Only reviews
    d. Only compilations and reviews

16. With respect to the AICPA peer review program, if a firm receives a “fail” in its reviewer’s grade, it means which of the following:
    a. There was one or more significant deficiencies
    b. There were at least three deficiencies
    c. There was a combination of more than one deficiency and a significant deficiency
    d. There was a series of the same deficiencies discovered over two consecutive peer reviews

17. Which of the following is an example of a coverage ratio:
    a. Days sales in receivables
    b. Times debt service is earned
    c. Altman Z score
    d. Inventory turnover

18. A factor that may indicate a potential going concern problem includes which one of the following:
    a. Unusually tight credit terms to customers
    b. The company is within a very competitive marketplace
    c. Continued operating losses
    d. Strong financial ratios such as the Altman Z Score

19. In searching for related party transactions, the auditor may wish to perform all of the following procedures <u>except</u>:
    a. Review material cash disbursements and other transactions
    b. Research the definition of related parties in accounting literature
    c. Discuss with other professionals about related parties
    d. Use the Internet to search records for the names of principals at the audit client to find other affiliated entities

20. Most lawsuits against auditors occur within which period of time:
    a. The first two years of the auditor's relationship
    b. Typically once there is a triggering event
    c. The first five years of the auditor's relationship
    d. The first seven years of the auditor's relationship

21. One conclusion reached based on court cases is that juries tend to hold accountants to the level of _____.
    a. Guarantors
    b. Auditors
    c. Legal consultants
    d. Financial advisors

22. Common pitfalls that continue to expose accountants to loss in litigation include all of the following <u>except</u>:
    a. Failure to maintain professional skills
    b. Working in areas and industries in which the accountant has too much expertise
    c. Unprofessional working habits
    d. Failure to maintain a good relationship with clients

23. The Top Ten Actions to minimize the risk of being sued include:
    a. Never sue to collect unpaid fees
    b. Take additional CPE courses
    c. Have two partners sign off on all workpapers
    d. Include arbitration clauses in all engagement letters

24. According to the AICPA, _____ has (have) proven to be one of the principal factors giving rise to liability claims against auditors.
    a. Overbilling clients
    b. Personality disputes between the client and the auditor
    c. Problem clients
    d. Missing deadlines

25. Which of the following is a symptom of an undesirable client:
    a. Client negotiates to reduce professional service fees
    b. Client has a strong financial condition and knows it
    c. Client lacks formal education
    d. Management chronically enters into material high-risk transactions

26. Generally, an auditor may be sued under which of the following causes of action:
    a. Lost profits
    b. Conversion
    c. Defamation
    d. Breach of contract

27. Auditors' responsibility to third parties can be categorized into four different categories that includes which one of the following:
    a. Passive liability
    b. Limited liability approach
    c. Restricted approach
    d. Near privity

28. In order to tighten up workpapers, the author recommends that an auditor do which one of the following:
    a. Include all "to do" lists, whether or not completed
    b. Complete the audit or review program
    c. Reduce workpaper overload
    d. Perform more tests of account balances and less analytical procedures

29. The author suggests that a firm can reduce time and increase audit efficiency by doing which one of the following:
    a. Take more work away from the client and its staff to avoid poorly prepared schedules
    b. Cut time down, particularly time allocated to planning the engagement
    c. Weed out unprofitable clients and increase fees
    d. Turn over staff often to reduce the average labor rate per employee

30. With respect to weeding out unprofitable clients, clients that are:
    a. High risk should be retained if the auditor receives an unusually high fee for the engagement
    b. High risk, slow payers, high maintenance and low profitability may not be worth keeping
    c. Low risk, fast payers, low maintenance and high profitability may not be worth keeping
    d. Only clients that require audits and reviews, but not compilation engagements, should be considered for weeding out

31. One way in which the author recommends saving time is to:
    a. Perform physical inventories right after year end
    b. Confirm trade payables
    c. Send lawyers letters at the same time
    d. Eliminate the request for cash cut-off statements

32. SAS No. 122, AU-C Section 505, *External Confirmation* (formerly SAS No. 67) states that negative confirmations of accounts receivables should not be used unless control risk is set at:
    a. Below maximum
    b. Maximum
    c. Less than 50% of maximum
    d. Zero

33. If attendance at a physical inventory is impractical, the auditor should:
    a. Resign from the engagement
    b. Perform alternative audit procedures
    c. Demand that the client reschedule the physical inventory within 60 days of year end
    d. Qualify his or her audit report

34. Under existing GAAP, which of the following is a proper GAAP application of the lower of cost or market rule to inventory:
    a. The rule may be applied on an individual item or total inventory basis
    b. The rule may be applied only on the total inventory and not an individual item basis
    c. The rule may be applied only on an individual item basis and not on the total inventory basis
    d. GAAP is silent as to how LCM should be applied

35. If an auditor has difficulty obtaining receivable confirmation replies from a large corporate customer, which of the following is an example of an alternative auditing procedure that can be applied as part of numerous alternative procedures:
    a. Send a confirmation by email with a reverse spam blocker filter
    b. Assume the receivable is not collectible and set up an allowance for bad debts for its balance
    c. Send out the confirmation certified mail, receipt requested
    d. Examine invoices of the customer that are included in the aging

36. If an accountant is asked to provide some form of a comfort letter to a lender for a client, which of the following is a statement that would be appropriate for the accountant to make to the lender:
    a. “The client is not insolvent”
    b. “The client has the ability to pay all of his or her debts”
    c. “The client has informed me that he is self employed”
    d. “The client’s business is profitable”

37. Harry Callahan is auditing the current year's 20X2 financial statements for X Corporation. The prior period 20X1 financial statements were audited by another auditor. In Harry's current year 20X2 audit report, Harry includes another-matter paragraph separating his responsibility for the 20X1 prior year financial statements. In the current year 20X2 management representation letter, how should Harry handle 20X1 representations:
    a. Harry is not required to obtain representations for 20X1 because he is not issuing an opinion on 20X1
    b. Harry must obtain representations for 20X1
    c. Harry is not allowed to obtain representations for 20X1
    d. Harry must obtain representations for 20X1 but insert a disclaimer related to those representations

38. Which of the following is true as it relates to the city and state where the auditor practices:
    a. The city and state must be placed under the auditor’s signature on the report in all cases
    b. The auditor is not permitted to place the city and state under the auditor’s signature if such information is presented in the firm’s letterhead on which the report is issued
    c. The SASs do not require the city and state to be named in the auditor’s report
    d. If the city and state is named in the firm’s letterhead on which the report is issued, it does not have to be presented below the auditor’s signature

39. A/An _____ is defined as deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
    a. Significant deficiency
    b. Error
    c. Irregularity
    d. Severe Deficiency

40. Jimmy is a CPA who is auditing Company B. Jimmy identifies a deficiency in internal control that does not rise to being either a significant deficiency or a material weakness. What action must Jimmy take, if any:
    a. Not a single thing has to be done
    b. Communicate with the board of directors
    c. Make an oral or written communication with management
    d. Modify the audit report

41. Which of the following is true as it relates to a situation in which there are no material weaknesses identified during an audit. The auditor _____stating that no material weaknesses were identified during the audit.
    a. Is not permitted to issue a written communication
    b. Is required to issue a written communication
    c. Is permitted to issue a written communication
    d. Is not permitted to issue an oral communication

42. Which is an example of a result that can occur if a CPA firm has a problem with a DOL employee benefit plan audit:
    a. The Form 5500 can be disqualified
    b. The CPA firm can be asked to take additional CPE
    c. Nothing can occur. The DOL has no authority over the CPA firm.
    d. The CPA firm can be fined by the AICPA and state CPA society

43. An employee benefit plan with _____ participants must have an audit as part of its Form 5500 filing:
    a. At least 25 full time
    b. More than 700
    c. 100 or more
    d. 75 or more

44. Company X is trying to reduce cheating in the company. Which of the following is NOT an action that might reduce cheating:
    a. Reduce the lighting so that the lights are dimmer than usual
    b. Hang mirrors with eyes on it
    c. Install mock cameras
    d. Have an honor code

45. Cheryl Tighe has a problem. She is an employee of a company. Cheryl likes to perpetrate fraud and enjoys the challenge of not getting caught. When she commits the fraud, she receives a “cheaters” high. What kind of fraudster or cheater is she:
    a. Isolated fraudster
    b. Perpetual fraudster
    c. Talented cheater
    d. Chronic cheater

46. What kind of fraudster is typically susceptible to the conditions of the fraud triangle:
    a. Perpetual fraudster
    b. Isolated fraudster
    c. Remorseful fraudster
    d. Recurring fraudster

47. Sly Stallone CPA is the partner in the CPA firm that is performing a PCAOB audit. Sly is shy and does not want his name disclosed under the new PCAOB rules. Which of the following must be disclosed under the PCAOB rules:
    a. The name of the engagement partner
    b. The home address of the engagement partner
    c. The name of each staff person who worked at least 200 hours on the engagement
    d. The number of lawsuits against the CPA firm over the past five years

48. Company Y has an internal audit function and is being audited by Jacque Cousteau CPA. The requirements in SAS No. 128 for Jacque using the work of Y's internal audit function to obtain audit evidence do not apply if _____.
    a. Y is a not-for-profit entity
    b. The activity is relevant to Jacque's audit
    c. The responsibilities and activities of the function are not relevant to Jacque's audit
    d. Jacque performs confirmation procedures

49. Mary is a CPA and external auditor of Company X which has an internal audit function. In accordance with SAS No. 128, which of the following is a procedure an external auditor should perform with respect to the work of an internal auditor:
    a. Make sure the internal auditors are at least CPAs or have a similar financial degree
    b. Obtain a representation letter from the internal auditors
    c. Obtain an engagement letter from the internal auditors
    d. Assess the competence and objectivity of the internal auditors

50. Gwen Stefanie, CPA is performing an audit of ICFR under SAS No. 130. Which of the following must Gwen obtain from management:
    a. Written assessment about the effectiveness of the entity's ICFR
    b. Flowchart of the entity's ICFR
    c. Narrative of the entity's ICFR
    d. Verbal discussion of the shortfalls in the effectiveness of the entity's ICFR

51. Britney Spears, CPA is performing an ICFR audit. In performing her audit, Britney should use a _____ approach to select the control test:
    a. Bottoms-up
    b. Top-down
    c. Lateral
    d. Substantial

52. D. Trump, CPA is performing an ICFR audit. Do must communicate to management all deficiencies during the integrated audit no later than _____ following the report release date.
    a. One Year
    b. 60 days
    c. Six months
    d. 30 days

53. Alice Mardon CPA is asked to perform certain engagements by several clients. Alice wants to know which standards she should follow. For which of the following engagements should Alice follow the attestation standards found in SSAE No. 18:
    a. Review of financial statements
    b. Compilation of financial statements
    c. Tax return preparation
    d. Prepare a feasibility study

54. Demi Moore, CPA is performing an attestation engagement under SSAE No. 18. Which of the following is true:
    a. Demi must be independent to perform all attestation engagement subject to one exception
    b. Demi must be independent to perform an examination engagement but not any other attestation engagements
    c. Demi does not have to be independent to perform any attestation engagement
    d. Demis does not have to be independent to perform a compilation engagement under SSAE No. 18

55. Which of the following is a type of attestation engagement to which SSAE No. 18 *does not apply*:
    a. Agreed-upon procedures engagement
    b. Preparation of financial statements engagement
    c. Financial forecast engagement
    d. Pro forma financial information engagement