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CPA AUD Study Guide

Auditing & Attestation — chapter-by-chapter review

2026 CPA Exam Blueprint · AICPA, PCAOB, GAGAS

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How to Use This Guide and the AUD Exam Format

This guide is a chapter-by-chapter review of the **Auditing and Attestation (AUD)** core section of the Uniform CPA Examination. It follows the same eighteen chapters as the AUD practice bank on UPractice.org, so you can read a chapter and then immediately drill the matching multiple-choice questions and simulations.

AUD is different from the other core sections. FAR and REG reward you for computing the right number; AUD mostly rewards you for **judgment**: deciding what the auditor should do next, which standard applies, which report fits the facts and which piece of evidence is more reliable. There are computations (materiality, audit risk, sampling, bank reconciliations, ratios), but most points come from understanding *why* auditors do what they do.

The AUD section at a glance

The CPA Exam has three core sections (AUD, FAR, REG) that every candidate takes, plus one discipline section of the candidate's choice (BAR, ISC or TCP).

Feature	AUD (2026 Blueprints)
Testing time	4 hours
Multiple-choice questions (MCQs)	78, in two testlets of 39
Task-based simulations (TBSs)	7, in three testlets (2, 3 and 2)
Total testlets	5
Score weighting	MCQs 50%, TBSs 50%
Score scale / passing score	0–99 / 75
Skill levels	Remembering and understanding 30–40%; Application 30–40%; Analysis 15–25%; Evaluation 5–15%

AUD is the only core section that tests the **Evaluation** skill level. Evaluation items ask you to judge something already done: is this documentation adequate, is this conclusion supported, is this report wording appropriate? Expect simulations that show you a draft report or a set of working papers and ask you to find what is wrong.

Content areas and weights

Blueprint area	Weight	Chapters in this guide
I. Ethics, Professional Responsibilities and General Principles	15–25%	1–4
II. Assessing Risk and Developing a Planned Response	25–35%	5–9
III. Performing Further Procedures and Obtaining Evidence	30–40%	10–13
IV. Forming Conclusions and Reporting	10–20%	14–18

The mapping is approximate. Sampling (Chapter 9) is tested both in planning (sample size) and in evidence (evaluating results); analytical procedures (Chapter 12) appear in planning, as substantive procedures and at completion. Government auditing and attestation engagements are spread across areas I, II and IV.

> **Exam tip:** Areas II and III together are 55–75% of the exam. Risk assessment, internal control, evidence and the specific account areas are where the points are. Do not spend half your study time on ethics trivia.

Which standards this guide uses

AUD tests several sets of standards. Every question tells you, directly or indirectly, which one applies. Knowing who issues what is half the battle.

Engagement or topic	Standards	Issued by
Audits of **nonissuers** (private companies, most not-for-profits, governments)	Statements on Auditing Standards (SASs), codified as **AU-C** sections — "GAAS"	AICPA Auditing Standards Board (ASB)
Audits of **issuers** (SEC registrants) and broker-dealers	PCAOB Auditing Standards (**AS** numbers)	Public Company Accounting Oversight Board
Attestation engagements (examinations, reviews, agreed-upon procedures)	Statements on Standards for Attestation Engagements (SSAEs), **AT-C** sections	AICPA ASB
Preparation, compilation and review of nonissuer financial statements	Statements on Standards for Accounting and Review Services (SSARS), **AR-C** sections	AICPA Accounting and Review Services Committee (ARSC)
Firm quality management (nonissuer practice)	SQMS No. 1 and No. 2, plus SAS No. 146 at engagement level	AICPA ASB
Government audits (federal awards, many state and local governments)	Government Auditing Standards (**GAGAS**, the "Yellow Book"), 2024 revision	U.S. Government Accountability Office (GAO)
Single audits of federal awards	Uniform Guidance, 2 CFR 200 Subpart F (2024 revision)	Office of Management and Budget (OMB)
Ethics for CPAs	AICPA Code of Professional Conduct; SEC and PCAOB independence rules for issuers	AICPA Professional Ethics Executive Committee; SEC; PCAOB

New standards are generally eligible for testing in the exam window that begins **six months after the later of issuance or effective date**, and old standards stay testable until the new ones are eligible. That is why this guide, like the bank, notes a few transition points:

- **SQMS No. 1 and No. 2** (firm quality management) replaced the old quality control standards; systems had to be designed and implemented by **December 15, 2025**.
- **SAS No. 145** (risk assessment) is fully in force: separate assessments of inherent and control risk, the spectrum of inherent risk and the expanded IT understanding.
- **SAS No. 149** (group audits) is effective for audits of periods ending on or after **December 15, 2026**. This guide teaches group-audit concepts that hold under both the extant standard and SAS No. 149, and flags the main differences.
- For issuer audits, **PCAOB QC 1000** (quality control) takes effect **December 15, 2026**, and **AS 1000** shortened the documentation completion window to **14 days**.

- The **single audit threshold** is **$1,000,000** of federal expenditures for fiscal years beginning on or after October 1, 2024.

> **Watch out:** Many older study materials still show the $750,000 single audit threshold, the 45-day PCAOB documentation window and the old "elements of quality control." Those are distractors now.

How each chapter is organized

Every chapter follows the same pattern:

1. **Plain-language explanation** of each rule that the bank tests.
2. **Key-number and comparison tables** — AICPA versus PCAOB, preparation versus compilation versus review, and so on.
3. **Worked examples** with every step shown. Every computation was run in Python and re-checked before it was printed.
4. **Exam tips, traps and memory tricks** in colored boxes.
5. **Key takeaways** — a short summary to reread the night before the exam.

Callout boxes use four colors: green for exam tips, blue for worked examples, red for common traps and purple for memory tricks.

Report-structure tables in Chapters 15–18 describe the **sections, their order and what each one says, in plain language**. The guide deliberately does not reproduce the illustrative report wording from the standards. On the exam you will be asked to recognize the right section, order or phrase — understanding what each part does is what earns those points.

A study plan that works

1. **Learn the vocabulary first.** Chapters 1–4 (ethics, independence, quality management, planning) are mostly rules you can memorize, and they set up the language of the rest of the guide.
2. **Master the risk model.** Chapters 5–8 are the heart of AUD. If you understand how assessed risk drives the nature, timing and extent of procedures, half the exam becomes logic rather than memory.
3. **Drill computations.** Materiality, audit risk, attribute and monetary unit sampling, bank reconciliations and ratios should become routine.
4. **Learn reporting as a decision grid.** Chapter 15's two-by-two grid (misstatement or scope limitation; material or pervasive) answers a large share of report questions.
5. **Read, then drill immediately.** After each chapter, do a timed set of 20–30 MCQs from the matching bank chapter, then its simulations. Review every explanation, including

for questions you got right.

6. **Take full mock exams** under 4-hour timing in the last two weeks, and send every miss back to its chapter.

Test-day strategy

- **Budget your time.** About 1.3–1.5 minutes per MCQ (roughly 100–115 minutes for 78 questions) leaves about 15–20 minutes per simulation.
- **Identify the engagement and the entity first.** Issuer or nonissuer? Audit, review, compilation, examination or AUP? Government or not? The same facts can have different answers under different standards.
- **Read the simulation requirement before the exhibits.** You will know what to look for and skip distractor data.
- **For reports, classify before you choose.** Is the problem a misstatement or an inability to obtain evidence? Is it material, or material and pervasive?
- **Answer every item.** There is no penalty for guessing, and simulations give partial credit.

> **Memory trick:** "Who, what, which book." Who is the client (issuer or not), what is the engagement (audit, review, attest), and which book applies (AU-C, AS, AR-C, AT-C, Yellow Book)? Answer those three before reading the options.

Key takeaways

- AUD: 4 hours, 78 MCQs and 7 TBSs in 5 testlets, 50/50 weighting, passing score 75. It is the only core section with Evaluation-level skills.
- Areas: Ethics 15–25%, Risk and planned response 25–35%, Further procedures and evidence 30–40%, Conclusions and reporting 10–20%.
- Always identify the client type and engagement type before applying a rule.
- Current points to remember: SQMS 1 and 2 in place since December 15, 2025; SAS 149 for periods ending on or after December 15, 2026; PCAOB QC 1000 from December 15, 2026; PCAOB documentation completion 14 days; single audit threshold $1,000,000.

1. AICPA Code of Professional Conduct

The AICPA Code of Professional Conduct is the ethics rulebook for AICPA members. Most state boards of accountancy adopt it or something close to it, so it effectively governs CPAs in practice. AUD tests the structure of the Code, the conceptual framework, and the specific rules on objectivity, competence, fees, commissions, confidentiality, records and advertising. Independence, the biggest single rule, has its own chapter (Chapter 2).

How the Code is organized

The Code has a short set of **Principles** (aspirational ideals) and three parts of **Rules** (enforceable), each supported by interpretations.

Part	Applies to	Examples of content
Preface	All members	Principles, how to use the Code, definitions
Part 1	**Members in public practice**	Independence, integrity and objectivity, general standards, compliance with standards, accounting principles, acts discreditable, fees, advertising, confidentiality, form of organization and name
Part 2	**Members in business** (industry, government, education)	Integrity and objectivity, general standards, compliance with standards, accounting principles, acts discreditable
Part 3	**All other members** (retired, unemployed)	Acts discreditable

A member who is both in public practice and in business (for example, a CPA who works as a controller and also prepares tax returns on weekends) follows Part 1 for the public practice work and Part 2 for the employment.

The six principles are **responsibilities, the public interest, integrity, objectivity and independence, due care**, and **scope and nature of services**. They are ideals that guide how the rules are interpreted, but they are not enforceable by themselves.

The conceptual framework

The Code cannot list every situation. When no specific rule or interpretation covers a relationship or circumstance, the member uses the **conceptual framework approach**:

1. **Identify threats** to compliance with the rules.
2. **Evaluate the significance** of each threat — would a reasonable and informed third party, weighing all the facts, conclude the threat is at an acceptable level?

3. If not, **apply safeguards** to eliminate the threat or reduce it to an acceptable level.
4. If safeguards cannot do that, **decline or end the service** (or, for independence, conclude that independence is impaired).

A specific prohibition always beats the framework. If an interpretation says a relationship impairs independence, no safeguard can fix it.

The seven threats

Threat	What drives it	Example
Adverse interest	The member's interests are opposed to the client's	The client threatens to sue the firm over last year's audit
Advocacy	The member promotes the client's position	Promoting the client's shares to investors
Familiarity	A long or close relationship makes the member too sympathetic	Same engagement partner for 14 years who socializes with the CEO
Management participation	The member takes on management's role	Approving the client's vendor invoices for payment
Self-interest	The member could benefit financially or otherwise	Significant fee dependence on one attest client
Self-review	The member must evaluate his or her own earlier work	Auditing balances built from journal entries the firm prepared
Undue influence	Someone coerces or pressures the member	The CEO says the firm will be fired unless it accepts a revenue cutoff

> **Memory trick:** "A-A-F-M-S-S-U" — Adverse, Advocacy, Familiarity, Management participation, Self-interest, Self-review, Undue influence. Ask "who benefits?" (self-interest), "whose work is it?" (self-review), "who is pushing?" (undue influence) and "whose job is it?" (management participation).

Safeguards

Safeguards come from three sources: the **profession, legislation or regulation** (education and CPE requirements, peer review, professional standards), the **client** (a competent board or audit committee, strong internal controls, a policy of using outside reviewers), and the **firm** (quality management policies, rotation, consultation, a second-partner review, separate teams).

Exam tip: Disclosure and client consent are not general-purpose safeguards. They cure some conflicts of interest and permit some commissions for non-attest clients, but they never cure an independence impairment or a contingent fee on an attest engagement.

Integrity and objectivity

The **Integrity and Objectivity Rule** applies to members in both public practice and business. A member must:

- maintain objectivity and integrity, be free of conflicts of interest,
- not knowingly misrepresent facts, and
- not subordinate his or her judgment to others.

Conflicts of interest

A conflict exists when a service for one client or employer is affected by a relationship with another party (two clients bidding for the same company, for example). The member must identify conflicts, evaluate the threat, and — if it can be reduced to an acceptable level — **disclose the conflict and obtain consent** from the affected clients. If confidentiality prevents disclosure, the member generally must decline.

Gifts and entertainment

Accepting or offering gifts or entertainment to or from a client is acceptable only if **reasonable in the circumstances** (considering the nature, frequency, value and the parties). For an attest client, an unreasonable gift also impairs independence.

Subordination of judgment — members in business

If a member in business believes a supervisor's accounting treatment would materially misstate the records, the member takes the concern to **higher levels of management** (and the audit committee or board if needed), considers **documenting** the matter and consulting counsel, and considers whether to continue the employment. The member must never knowingly make or allow false entries; resignation and contacting regulators are considerations, not automatic duties.

General standards, compliance with standards and accounting principles

General Standards Rule

Every professional service must satisfy four general standards:

Standard	Meaning
Professional competence	Undertake only services the member (or firm) can reasonably expect to complete with competence — the member may gain competence through research, consultation or hiring specialists
Due professional care	Exercise due care in performing services
Planning and supervision	Adequately plan and supervise the work
Sufficient relevant data	Obtain sufficient relevant data to afford a reasonable basis for conclusions

Lack of competence at the start is not a violation if the member obtains it before completing the work. Accepting an engagement with no plan to become competent is.

Compliance With Standards Rule

Members must comply with standards issued by bodies designated by AICPA Council: the **ASB** (SASs, SSAEs, SQMSs), the **ARSC** (SSARS), the **PCAOB** (issuer audits), and the AICPA committees for consulting services, tax services (Statements on Standards for Tax Services) and forensic and valuation services.

Accounting Principles Rule

A member may not state that financial statements conform to GAAP (or give positive or negative assurance to that effect) if they contain a **departure from a designated accounting standard** that materially affects the statements. The designated **accounting** bodies are:

- **FASB** — U.S. GAAP for nongovernmental entities
- **GASB** — state and local governments
- **FASAB** — federal government entities
- **IASB** — International Financial Reporting Standards

The rare exception: in **unusual circumstances** where following the standard would make the statements misleading, the member may accept a departure if the report describes the departure, its approximate effects and why compliance would be misleading.

> **Memory trick:** "**F**our **A**ccounting setters **G**overn **I**ndustry" — FASB, FASAB, GASB, IASB set accounting rules; ASB, ARSC and PCAOB set auditing and review rules.

Acts discreditable

The **Acts Discreditable Rule** applies to every member, including those in business and retired members. Common acts discreditable:

Act	Notes
Retaining **client-provided records** after the client requests them	Applies even if fees are unpaid
Discrimination and harassment in employment practices	Final determination by a court or agency
Failing to follow **government audit requirements** (such as GAGAS) when the engagement requires them	Includes requirements of governmental bodies, commissions or regulatory agencies
Negligently making or allowing false or misleading entries in financial statements or records	Members in business too
Failing to file one's own tax return or remit payroll and other taxes	Also failing to file a client's return the member was engaged to file
Soliciting or disclosing **CPA Examination questions or answers**	
Using confidential information obtained from an employer or client for personal advantage	
Making false or misleading claims about qualifications in advertising	

Records requests

The Code separates four kinds of records:

Record type	Must the member provide it on request?
Client-provided records (the client's own documents given to the member)	**Yes, always** — even if fees are unpaid
Member-prepared records (journal entries, depreciation schedules the member prepared that the client has not received)	Yes, but **may be withheld** if fees for that specific work are unpaid
Member's work products (a completed tax return, the issued financial statements)	Yes, but may be withheld if fees for that work are unpaid or the work is incomplete
Working papers (the member's audit documentation)	**No** — working papers belong to the member

Records should be returned within a reasonable time; the Code treats **45 days** as generally reasonable. The member may charge a reasonable fee for the time and expense of retrieving and copying records, and may keep copies.

> **Memory trick:** "Their papers go home, my papers stay home." Client-provided records always go back; the CPA's working papers stay with the CPA.

Fees, commissions and referral fees

Contingent Fees Rule

A contingent fee depends on a finding or result (for example, a percentage of a refund or of loan proceeds). A member in public practice may **not** charge a contingent fee:

- to a client for which the member or firm performs an **audit or review** of financial statements, a **compilation** expected to be used by third parties when the report does not disclose a lack of independence, or an **examination of prospective financial information** — during the period of the engagement and the period covered by the historical statements; or
- for preparing an **original or amended tax return or claim for a tax refund**.

Contingent fees **are** allowed for non-attest clients in other situations, including:

Permitted contingent fee (non-attest client)	Why allowed
Representing a client in an **IRS examination** of a return	Outcome is decided by a third party
Filing an amended return based on a **tax issue under litigation** in another case or a published position	
Fees fixed by courts or public authorities	Not contingent in the Code's sense
Consulting or advisory work for non-attest clients (for example, a cost-reduction study)	No attest relationship

Commissions and Referral Fees Rule

- **Commissions** (for recommending or referring a product or service of a third party) are **prohibited** if the member performs an audit, review, certain compilations or an examination of prospective financial information for that client during the period.
- For any other client, a permitted commission must be **disclosed to the client**.
- **Referral fees** (paid or received for recommending or referring the services of a CPA) are not banned for attest clients but must always be **disclosed** to the client.

Watch out: Disclosure does not make a commission acceptable when the client is an audit client. The prohibition is absolute during the attest period.

Advertising, confidentiality and firm names

Advertising and Other Forms of Solicitation Rule

Advertising is allowed if it is not **false, misleading or deceptive**. Prohibited examples: guaranteeing results ("we will win your IRS appeal"), implying influence with a court or regulator, unjustified expectations of favorable results, and fee claims the member knows are likely to be substantially increased without telling the client. Coercion, overreaching or harassing conduct is also prohibited.

Confidential Client Information Rule

A member in public practice may not disclose confidential client information without the client's **specific consent**. The rule does **not** prevent a member from:

Exception	Example
Meeting professional obligations under the Compliance With Standards and Accounting Principles Rules	Modifying a report for a GAAP departure
Complying with a **validly issued and enforceable subpoena or summons** or laws and regulations	Court-ordered production of working papers
A **peer review** or quality review	Reviewer inspects engagement files
Responding to an **ethics investigation or disciplinary proceeding** of the AICPA, a state CPA society or a state board	
Initiating a complaint with, or responding to, a recognized investigative or disciplinary body	

A lender's promise to keep information private, or the member's belief that disclosure would help the client, is **not** consent.

A firm considering the sale of its practice may let a prospective buyer review client information without consent if the buyer agrees to keep it confidential.

Form of Organization and Name Rule

Firms may practice in any form allowed by state law. The firm name may not be **misleading** — for example, implying a network, size, or specialization the firm does not have. A firm may use "and Company" or the names of past owners. Non-CPA owners are allowed if CPAs own a **majority** of the financial interests and voting rights and the firm meets other conditions.

Worked examples

Example: Classifying a threat. A firm audits Delmar Freight. Last year the firm also designed Delmar's new revenue system. This year, the audit team must test general IT controls over that system.

- Who did the earlier work? The firm.
- What does the team now evaluate? The results of the firm's own design work.
- Classification: **self-review threat**. Under the independence rules, designing or implementing a client's financial information system for an attest client generally impairs independence (see Chapter 2), so no safeguard cures it.

Example: Contingent fee — allowed or not? A CPA has three requests:

1. An audit client offers a fee of 2% of the bank loan it obtains with the audited statements. **Not allowed** — contingent fee for an attest client.
2. A non-attest client asks the CPA to prepare its original return for 15% of the refund. **Not allowed** — original tax returns are always excluded.
3. The same non-attest client asks the CPA to represent it in an IRS examination for 20% of the tax saved. **Allowed** — IRS examination representation is an exception for non-attest clients.

Example: Records request with unpaid fees. A client that owes the CPA $6,000 for last year's compilation fires the CPA and asks for (a) its bank statements and invoices it provided, (b) the adjusting entries the CPA proposed but never gave the client, and (c) the CPA's working papers.

- (a) Client-provided records: **must return**, unpaid fee or not.
- (b) Member-prepared records related to the unpaid work: **may withhold** until the fee is paid.
- (c) Working papers: **need not provide** — they belong to the CPA.

Common traps

- Thinking members in industry are outside the Code. Parts 2 and 3 apply to members not in public practice; the Integrity and Objectivity and Acts Discreditable Rules apply to everyone.
- Treating disclosure as a cure for a contingent fee or commission with an attest client.
- Confusing client-provided records (always returned) with member-prepared records (may be withheld for unpaid fees for that work).

- Listing the ASB or PCAOB as a designated *accounting* body. They set auditing standards.
- Believing confidentiality prevents responding to a valid subpoena or a peer reviewer.

Key takeaways

- Structure: Principles + Rules; Part 1 public practice, Part 2 business, Part 3 other members.
- Conceptual framework: identify threats, evaluate, apply safeguards, or decline. Seven threats: adverse interest, advocacy, familiarity, management participation, self-interest, self-review, undue influence.
- General standards: competence, due care, planning and supervision, sufficient relevant data.
- Designated accounting bodies: FASB, GASB, FASAB, IASB.
- Contingent fees banned for attest clients and for original/amended returns and refund claims; IRS exam representation is allowed for non-attest clients.
- Commissions banned for attest clients; permitted commissions and all referral fees must be disclosed.
- Client-provided records go back on request (45 days generally reasonable) even with unpaid fees; working papers stay with the CPA.
- Confidentiality exceptions: valid subpoena, compliance with standards, peer review, ethics investigations, consent.

2. Independence (AICPA, SEC, PCAOB, GAO)

Independence is the foundation of every attest engagement. Without it, an audit opinion or review conclusion has no value to users. AUD tests four overlapping rule sets — the AICPA Code, the SEC rules, the PCAOB rules and the GAO's Government Auditing Standards — and the exam expects you to know which one applies and where they differ.

What independence means

Independence has two parts:

- **Independence of mind** — the state of mind that lets a practitioner act with integrity, objectivity and professional skepticism.
- **Independence in appearance** — avoiding circumstances that would cause a reasonable and informed third party to conclude that integrity, objectivity or skepticism had been compromised.

Independence is required for **attest** engagements: audits, reviews, examinations, and agreed-upon procedures (AUP). It is **not** required for a compilation (if the lack of independence is disclosed), a preparation engagement, tax work or consulting for a non-attest client.

The period that matters

Under the AICPA rules, independence must exist during:

1. the **period of the professional engagement** — from signing the engagement letter or starting the work (whichever is earlier) until the attest relationship ends; and
2. the **period covered by the financial statements** (for most financial interests and relationships).

> **Exam tip:** A financial interest disposed of **before** the engagement period starts generally does not impair independence even if held during the period covered by the statements — but certain relationships (such as being a client officer during the covered period) still do. Read the dates carefully.

Covered members

The AICPA financial-interest rules apply to **covered members** — not to everyone at the firm.

Covered member	Notes
Individuals on the **attest engagement team**	Includes staff, specialists who perform attest procedures, and the engagement quality reviewer
Individuals in a position to **influence** the attest engagement	Those who supervise or evaluate the engagement partner, consultation and quality reviewers
Partners and managers who provide **10 or more hours** of nonattest services to the client	
Partners in the office where the lead attest engagement partner primarily practices	Whether or not they work on the engagement
The firm, including its employee benefit plans	
Entities whose policies a covered member or the firm can control	

Other partners and professional employees are not covered members, but there are still limits: any partner or professional employee who owns **more than 5%** of an attest client impairs independence, and certain employment relationships with the client do too.

Immediate family and close relatives

Relationship	Rule
Immediate family (spouse, spousal equivalent, dependents)	Their financial interests are treated as the covered member's own
Immediate family **employment** at the client	Generally permitted, unless the position is a **key position** (one with primary responsibility for significant accounting functions or the financial statements, or able to influence their content)
Close relatives (parents, siblings, nondependent children)	Impair independence if the close relative holds a key position at the client, or holds a financial interest that is **material to the relative** and that the covered member knows about, or that lets the relative exercise significant influence over the client

> **Watch out:** A **nondependent** adult child is a close relative, not immediate family. The child's stock in a client impairs independence only under the materiality-and-knowledge or significant-influence tests — it is not automatically the covered member's own interest.

Financial interests

Interest	Effect on independence
Direct financial interest of a covered member (any amount)	**Impaired**
Material indirect financial interest of a covered member	**Impaired**
Immaterial indirect interest (for example, a diversified mutual fund holding a client)	Not impaired
Covered member is a trustee or executor of a trust or estate that holds a direct or material indirect interest in the client	Impaired if the covered member has authority to make investment decisions, the trust's interest is more than 10% of its assets, or the trust owns more than 5% of the client
A partner or professional employee (not a covered member) owns **more than 5%** of the client	Impaired

A mutual fund share is a **direct** interest in the fund. Whether it is a direct or indirect interest in the fund's holdings depends on the fund: owning 5% or less of a diversified fund is generally treated as an immaterial indirect interest in the underlying holdings.

> **Memory trick:** "**Direct = dead, indirect = depends** (on materiality)."

Loans with attest clients

Loans **from** a client that is a financial institution are generally prohibited, with these exceptions.

Permitted loan or account (if made under normal lending terms)	Condition
Automobile loans and leases collateralized by the vehicle	Normal terms
Loans fully **collateralized by cash** deposits at the same institution	
Loans against the **cash surrender value** of an insurance policy	
Credit cards and overdraft reserve accounts	Aggregate outstanding balance reduced to **$10,000 or less** by the payment due date
Grandfathered loans — home mortgages, other secured loans, and immaterial unsecured loans obtained before the person became a covered member or before the lender became an attest client	Must remain current under the original terms

Deposits in a client bank are fine if they are fully insured, or if any uninsured amounts are immaterial or the bank is unlikely to have financial difficulty.

Other relationships that impair independence

- **Employment**: a partner or professional employee who is simultaneously a director, officer, employee, promoter, underwriter, voting trustee or trustee of a pension plan of the client.
- **Former firm personnel at the client** in a key position: independence is impaired unless the person's payments from the firm are fixed and immaterial, the person no longer participates in firm activities, and the firm considers whether to change the engagement plan.
- **Seeking employment** with the client: a member of the engagement team who is considering employment with the client must report it and be removed from the team.
- **Unpaid fees**: independence is impaired if fees for **any** professional service performed **more than one year before the date of the current-year report** remain unpaid when the report is issued.
- **Litigation**: actual or threatened litigation between the client (or its management) and the firm alleging deficient audit work, or the firm alleging fraud by management, impairs independence.
- **Gifts**: accepting gifts that are not clearly insignificant to the recipient.

Nonattest services to attest clients (AICPA)

A firm may provide nonattest services (bookkeeping, tax, consulting) to a nonissuer attest client if it meets the **general requirements**:

1. The firm does **not assume management responsibilities**.
2. The client agrees to take responsibility and designates an individual with **suitable skill, knowledge or experience** (not necessarily expertise) to oversee the service.
3. The client evaluates the adequacy and results of the service, makes all decisions, and accepts responsibility for the results.
4. The firm **documents in writing** the understanding with the client (objectives, services, client acceptance of responsibilities, firm responsibilities, limitations).

Management responsibilities that always impair independence include: setting policy or strategic direction, directing employees, authorizing or executing transactions, having custody of client assets, deciding which recommendations to implement, reporting to the board on behalf of management, designing or maintaining internal controls, and **designing, developing or implementing a financial information system** (implementation of an off-the-shelf package can be acceptable in limited cases).

> **Exam tip:** When the firm prepares the financial statements for an attest client, the **self-review threat** may be significant. The firm must evaluate it and apply safeguards (for example, having someone not on the attest team prepare the statements) unless the client has the skill to oversee the work.

SEC and PCAOB rules for issuers

For **issuers** (public companies registered with the SEC), the Sarbanes-Oxley Act of 2002, SEC rules and PCAOB rules add stricter requirements.

Prohibited nonaudit services

The auditor of an issuer may **not** provide these services to the audit client:

Prohibited service	Short reason
Bookkeeping or other services related to the client's accounting records or financial statements	Self-review
Financial information systems design and implementation	Self-review, management participation
Appraisal or valuation services, fairness opinions, contribution-in-kind reports	Self-review
Actuarial services	Self-review
Internal audit outsourcing	Management participation, self-review
Management functions or human resources	Management participation
Broker-dealer, investment adviser or investment banking services	Advocacy
Legal services and expert services unrelated to the audit	Advocacy

Services not on the list — including most **tax services** — are allowed only if **pre-approved by the audit committee**. The PCAOB adds restrictions on tax services: the auditor may not provide tax services to a person in a **financial reporting oversight role** at the client (or to an immediate family member), may not market or plan **aggressive tax positions** (confidential or listed transactions), and may not use contingent fees.

Partner rotation and cooling-off

Rule	Requirement
Lead (engagement) partner and **engagement quality review partner**	Rotate after **5 years**, then **5-year** time-out
Other **audit partners** (significant subsidiaries, other partners with significant contact)	Rotate after **7 years**, then **2-year** time-out
Cooling-off before a former audit team member takes a financial reporting oversight role (CEO, CFO, controller, chief accounting officer) at the issuer	**One year** — otherwise the firm's independence is impaired
Audit partner compensation	May not be based on selling non-audit services to the audit client

> **Memory trick:** Rotation "**Lead 5-5, others 7-2**." Cooling-off is "one year before you cross the street."

Other issuer rules

- The **audit committee** appoints, compensates and oversees the auditor, and pre-approves all audit and permitted nonaudit services.
- **PCAOB Rule 3526** requires the auditor to describe in writing to the audit committee all relationships that may reasonably bear on independence, discuss them, and **affirm independence** — before accepting a new engagement and at least annually.
- The **SEC's general standard**: the SEC will not recognize an auditor as independent if a reasonable investor with knowledge of all relevant facts would conclude the auditor cannot exercise objective and impartial judgment. The SEC focuses on four principles: the auditor should not (1) have a mutual or conflicting interest with the client, (2) audit its own work, (3) act as management or an employee, or (4) act as an advocate for the client.

GAO (Government Auditing Standards)

GAGAS uses a **conceptual framework** similar to the AICPA's, with these threats: self-interest, self-review, bias, familiarity, undue influence, management participation and structural.

GAGAS threat	Typical example
Self-interest	An auditor's spouse works in the program being audited
Self-review	The audit organization prepared the data it now audits
Bias	The auditor holds strong political or ideological views about the program
Familiarity	Long association with the audited entity's management
Undue influence	Management restricts the time allowed for the audit
Management participation	The auditor makes program decisions
Structural	An internal audit organization reports to the official whose program it audits

Key GAGAS points:

- Independence of mind and in appearance is required for all GAGAS engagements (financial audits, attestation engagements, reviews of financial statements and performance audits).
- For nonaudit services, auditors must assess whether management has the **skills, knowledge or experience** to oversee the service, and must **document** that assessment and the understanding with management.

- Certain nonaudit services always impair independence, such as assuming management responsibilities, and preparing accounting records in some circumstances; others require evaluating threats.
- GAGAS independence rules apply **in addition** to the AICPA rules when the engagement is under GAGAS. The auditor follows the **stricter** requirement.

Worked examples

Example: Covered member or not? Mei is a tax partner in the firm's Boston office. The lead partner on the audit of Eastgate Textiles practices in the firm's Chicago office. Mei provided 6 hours of tax advice to Eastgate this year and owns 200 shares of Eastgate.

- On the engagement team? No.
- In a position to influence the engagement? No.
- Partner who provided 10 or more hours of nonattest services? No — only 6 hours.
- Partner in the lead partner's office? No — Boston, not Chicago.
- Mei is **not** a covered member, so her shares do not impair independence unless she owns **more than 5%** of Eastgate. If her tax work reaches **10 hours**, she becomes a covered member and must dispose of the shares.

Example: Credit card balance. A senior on the audit of a client bank has a credit card from the bank. On the statement date she owes $14,200; she pays $5,000 by the due date.

- Balance after payment: $14,200 − $5,000 = **$9,200**.
- The aggregate outstanding balance is reduced to $10,000 or less by the payment due date, so independence is **not** impaired. Had she paid only $4,000 (leaving $10,200), independence would be impaired.

Example: Unpaid fees. The firm is about to issue its report on Alder Creek Foods' 20X5 statements on March 10, 20X6. Alder Creek still owes the firm for tax work performed in January 20X5.

- The tax work was performed more than one year before the date of the current report (January 20X5 is more than one year before March 10, 20X6).
- Unpaid fees for that work impair independence. The firm must collect the fee before issuing the report (or not issue it).

Common traps

- Believing disclosure in the auditor's report cures an independence impairment in an audit or review. Only a compilation report can disclose a lack of independence.
- Treating every firm partner as a covered member. Check the six covered-member categories.
- Thinking a nondependent child's holdings are immediate family holdings.
- Applying AICPA rules to an issuer question that involves a prohibited SOX service — the SEC/PCAOB list controls.
- Confusing SEC rotation periods (5/5 for lead and EQR partners; 7/2 for others).

Key takeaways

- Independence is required for audits, reviews, examinations and AUP — of mind and in appearance — during the engagement period and the period covered.
- Covered members: team, those who can influence, partners/managers with 10+ hours of nonattest services, partners in the lead partner's office, the firm.
- Any direct or material indirect financial interest impairs independence; any partner or professional employee owning more than 5% impairs independence.
- Permitted loans: car loans, cash-collateralized loans, insurance policy loans, credit cards at $10,000 or less by the due date, grandfathered loans.
- Unpaid fees more than one year old at the report date impair independence.
- Issuers: prohibited services list, audit committee pre-approval, rotation 5/5 and 7/2, one-year cooling-off, PCAOB Rule 3526 annual communication.
- GAGAS adds bias and structural threats and requires documenting management's ability to oversee nonaudit services.

3. Quality Management (SQMS 1 & 2)

Quality management is about the firm, not a single engagement. A firm that performs audits, reviews, compilations, preparation engagements or attestation engagements must have a system that gives it reasonable assurance that it and its people meet professional standards and issue appropriate reports. For nonissuer practice that system is now governed by the AICPA's **Statements on Quality Management Standards (SQMS)**; issuer practice follows PCAOB rules. AUD tests the components of the system, engagement quality reviews, the engagement partner's role, documentation timelines and peer review.

The standards at a glance

Standard	Covers	Effective
SQMS No. 1, *A Firm's System of Quality Management*	The firm-wide, risk-based system	Systems designed and implemented by **December 15, 2025**; first evaluation within one year after that
SQMS No. 2, *Engagement Quality Reviews*	Appointment, eligibility and work of the engagement quality reviewer	Same date
SAS No. 146 (AU-C 220), *Quality Management for an Engagement*	Engagement partner's responsibilities on each audit	Audits of periods beginning on or after December 15, 2025
PCAOB **AS 1220**, *Engagement Quality Review*	EQ reviews on issuer audits	In force
PCAOB **QC 1000**, *A Firm's System of Quality Control*	Issuer firms' systems	**December 15, 2026**

The old approach (SQCS No. 8, with six "elements of quality control") was replaced by a **risk-based** approach: the firm sets quality objectives, identifies and assesses **quality risks** that could prevent it from meeting them, and designs and implements **responses** to those risks.

The eight components of SQMS No. 1

#	Component	What it addresses — plain words
1	**The firm's risk assessment process**	Setting quality objectives, identifying and assessing quality risks, designing responses; updating them when conditions change
2	**Governance and leadership**	Culture and tone at the top, commitment to quality, leadership accountability, organizational structure, resource allocation
3	**Relevant ethical requirements**	Independence and other ethics — identifying threats, monitoring personal investments, rotation
4	**Acceptance and continuance** of client relationships and specific engagements	Integrity of the client, the firm's competence and resources, ability to comply with ethics
5	**Engagement performance**	Direction, supervision and review; consultation; differences of opinion; engagement quality reviews; documentation
6	**Resources**	Human resources (hiring, training, evaluation), technological resources, intellectual resources (methodology, guides) and service providers
7	**Information and communication**	Obtaining, generating and communicating relevant information internally and externally
8	**The monitoring and remediation process**	Monitoring activities, evaluating findings, identifying deficiencies, investigating root causes and remediating

Memory trick: "**Really Good Ethics Attract Engaged Resourceful Information Monitors**" — Risk assessment, Governance, Ethics, Acceptance, Engagement performance, Resources, Information and communication, Monitoring.

Watch out: Do not confuse SQMS No. 1's **eight** components with COSO's **five** components of internal control (control environment, risk assessment, control activities, information and communication, monitoring). Both have "risk assessment," "information and communication" and "monitoring," which is exactly why the exam mixes them.

Responsibilities within the firm

- The firm's **chief executive officer or managing partner** (or the managing board) has **ultimate responsibility and accountability** for the system.
- Leadership assigns **operational responsibility** for the system, for compliance with independence requirements and for the monitoring and remediation process to

individuals with appropriate experience, authority and time.
- The individual with ultimate responsibility must **evaluate** the system at least **annually** and conclude whether it provides reasonable assurance that its objectives are met — or that it does, except for deficiencies that are severe but not pervasive, or that it does not.

Deficiencies in the system

A **deficiency** exists when a quality objective required for the system is not established, a quality risk is not identified or properly assessed, a response is missing or not properly designed or implemented, or another aspect of the system is missing or not operating effectively. The firm evaluates the severity and pervasiveness of deficiencies, investigates **root causes**, and takes remedial action.

A **finding** (information about the system that the firm learns from monitoring, inspections or other sources) is not automatically a deficiency; the firm evaluates whether it indicates one.

Monitoring activities

Monitoring includes **ongoing** activities (built into day-to-day processes) and **periodic** activities (for example, cyclical inspection of completed engagements, with each engagement partner's work inspected on a periodic basis). The firm must take care that the people performing monitoring are objective — they should not monitor their own engagements.

External information also feeds the monitoring process: **peer review** results, regulatory inspections and complaints or allegations.

Engagement quality reviews (SQMS No. 2)

An **engagement quality review (EQR)** is an objective evaluation of the significant judgments made by the engagement team and the conclusions reached, completed **on or before the date of the report**.

When is an EQR required?

Under SQMS No. 1, the firm must establish policies that require an EQR for:

- audits or other engagements for which an EQR is **required by law or regulation**, and
- engagements for which the firm determines an EQR is an appropriate **response to assessed quality risks** (for example, by reference to risk criteria such as public interest, unusual circumstances or industry).

An EQR is **not** required for every engagement.

Eligibility of the reviewer

Requirement	Detail
Competence and authority	Sufficient knowledge, experience and authority, including time
Objectivity	Not a member of the engagement team; did not make the decisions being reviewed
Ethical requirements	Independent of the client
Cooling-off	A former **engagement partner** may not become the EQ reviewer on that engagement until **two years** have passed (or longer if ethics require)
Assistance	The reviewer may use assistants with the needed competence, but keeps responsibility

What the EQ reviewer does

The reviewer reads and discusses significant matters and judgments with the engagement partner, reviews selected documentation, evaluates the basis for significant judgments (including professional skepticism), evaluates whether the firm's independence requirements were met, considers whether difficult or contentious matters were consulted on, and reviews the financial statements and the proposed report.

The engagement partner **may not date the report** until the EQ reviewer notifies the partner that the review is complete. If the reviewer has unresolved concerns, the firm's policies for resolving differences of opinion apply.

EQ review on issuer audits (AS 1220)

PCAOB AS 1220 requires an EQ review for **every** issuer audit and review of interim financial information. The reviewer must give **concurring approval of issuance** before the client may use the report. The reviewer must be a partner or equivalent, have competence, be independent and objective, and is subject to a **two-year cooling-off** if he or she was the engagement partner.

> **Exam tip:** "EQR required on every engagement?" is a classic trap. Nonissuer: only where law/regulation requires it or the firm's policies call for it. Issuer: yes, AS 1220 requires one on every audit.

Engagement partner responsibilities (SAS No. 146)

The engagement partner has overall responsibility for managing and achieving quality on the audit, and must be **sufficiently and appropriately involved** throughout. Key duties:

- Creating an environment that emphasizes quality and the expected behavior of team members.

- Being satisfied that **relevant ethical requirements**, including independence, are met.
- Being satisfied that acceptance and continuance procedures were followed and conclusions are appropriate.
- Determining that sufficient and appropriate **resources** are assigned in a timely manner.
- Taking responsibility for **direction, supervision and review**, and reviewing documentation at appropriate points, including significant matters and judgments.
- Taking responsibility for consultation on difficult or contentious matters and for resolving **differences of opinion**.
- Before dating the report, being satisfied that significant judgments and conclusions are supported by **sufficient appropriate evidence**.

The engagement partner may assign procedures or tasks to other members of the team, but keeps overall responsibility.

Audit documentation timelines

Item	AICPA (nonissuers)	PCAOB (issuers)
Report date	Date sufficient appropriate evidence has been obtained	Same
Assembly / documentation completion	Within **60 days** after the **report release date**	Within **14 days** after the report release date (AS 1000; phased in, applicable to all firms for fiscal years beginning on or after December 15, 2025)
Retention	At least **5 years** from the report release date (or longer by law)	**7 years** from the report release date
Changes after assembly	No deletion or discarding; additions must be documented (who, when, why)	Same idea; additions must indicate date, who made them and the reason

> **Memory trick:** "**60/5 versus 14/7**" — AICPA assembles in 60 days and keeps for 5 years; PCAOB completes in 14 days and keeps for 7 years.

Documentation is the property of the auditor, but it must be protected from unauthorized access and kept confidential (Chapter 1).

Peer review

Firms that perform audits, reviews, compilations or examinations under AICPA standards must enroll in the **AICPA Peer Review Program** (state boards typically require it for

licensure). Peer reviews occur once every **three years**.

Type	Who gets it	Focus
System review	Firms that perform engagements under the SASs, GAGAS, or examinations under the SSAEs	The firm's system of quality management and its compliance, tested by engagement selection
Engagement review	Firms whose highest-level work is reviews and compilations under SSARS, or certain SSAE engagements (not examinations)	Whether selected engagements were performed and reported on in conformity with standards

Possible ratings: **pass**, **pass with deficiency(ies)**, or **fail**.

Firms that audit issuers are also subject to **PCAOB inspections**: annually for firms that issue audit reports for more than 100 issuers, and at least every three years for others.

Example: Which component? For each item, identify the SQMS No. 1 component.

1. The managing partner announces that no partner will be rewarded for revenue growth at the expense of audit quality. **Governance and leadership.**
2. Before agreeing to audit a cryptocurrency exchange, the firm considers whether it has staff with digital-asset expertise. **Acceptance and continuance.**
3. The firm updates its audit methodology for new standards and puts it on the intranet. **Resources** (intellectual resources).
4. After inspecting files, the firm finds weak documentation of estimates, investigates why, and adds training. **Monitoring and remediation.**
5. The firm identifies a new quality risk when it begins auditing employee benefit plans. **The firm's risk assessment process.**

Example: Documentation deadlines. The auditor of a private company releases the report on March 20, 20X6.

- Assembly deadline: 60 days after March 20 = **May 19, 20X6** (March has 11 remaining days, April 30, May 19: 11 + 30 + 19 = 60).
- Retention: at least 5 years from March 20, 20X6, that is, until at least **March 20, five years later**.
- If this had been an issuer audit, completion would be due **April 3, 20X6** (14 days) and retention would run 7 years.

Example: EQ reviewer eligibility. Hana was the engagement partner on the audit of Brightwater Clinics (a nonissuer) for 20X3, then rotated off. The firm wants her to be the EQ reviewer for the 20X5 audit.

- She was the engagement partner on this engagement, so the two-year cooling-off applies.
- Her last year as engagement partner was 20X3. The audits of 20X4 and 20X5 fall inside the two-year cooling-off period.
- The earliest audit she may review is **20X6**. The firm must appoint a different EQ reviewer for 20X5.

Common traps

- Mixing up SQMS 1's eight components with COSO's five.
- Thinking an EQ review is required for every nonissuer engagement.
- Using the PCAOB 14-day completion window for a nonissuer audit, or the 60-day AICPA window for an issuer.
- Dating the report before the EQ reviewer has finished.
- Believing that a monitoring finding is automatically a deficiency.

Key takeaways

- SQMS No. 1: risk-based system with eight components; in place since December 15, 2025; evaluated at least annually; ultimate responsibility with the CEO/managing partner.
- SQMS No. 2: EQ reviewer must be competent, objective, independent; two-year cooling-off for a former engagement partner; report not dated until the EQR is complete.
- SAS No. 146: the engagement partner manages quality on each audit and must be sufficiently and appropriately involved.
- Documentation: AICPA 60 days / 5 years; PCAOB 14 days / 7 years.
- Peer review every three years (system or engagement review); ratings pass, pass with deficiency(ies), fail. PCAOB inspects large issuer firms annually.

4. Engagement Acceptance & Planning

Every audit starts with two questions: *should we take this client?* and *how will we do the work?* AUD tests the preconditions for an audit, communications with a predecessor auditor, the engagement letter, the overall strategy and audit plan, and communications with those charged with governance. These are mostly rules you can learn, and they set the stage for the risk chapters that follow.

Preliminary engagement activities

Before starting an audit (and at the start of each recurring audit) the auditor:

1. Performs **acceptance or continuance** procedures for the client relationship and the engagement.
2. Evaluates compliance with **ethical requirements, including independence** (Chapter 2).
3. Establishes an **understanding of the terms** of the engagement with management (and, where appropriate, those charged with governance).

Preconditions for an audit

The auditor may accept an audit only if the **preconditions** are present:

Precondition	What the auditor does
An **acceptable financial reporting framework**	Determine that the framework management uses (GAAP, IFRS, a special purpose framework such as the cash or tax basis) is acceptable
Management **acknowledges and understands its responsibilities**	For preparation and fair presentation of the statements; for designing, implementing and maintaining internal control relevant to their preparation; and for providing the auditor with access to all information, additional information requested and unrestricted access to people

If the preconditions are not present, the auditor discusses the matter with management and, unless required by law or regulation, does **not accept** the engagement.

> **Watch out:** If management or those charged with governance impose a **scope limitation** before acceptance that would cause the auditor to **disclaim** an opinion, the auditor should not accept the engagement (unless law or regulation requires it).

Other acceptance considerations

- **Integrity of management** — inquiries of third parties (bankers, attorneys), background searches and predecessor communications.
- **Competence and resources** — whether the firm has people with the industry knowledge and time to do the work.
- **Independence** — any impairments must be resolved before acceptance.

Communicating with the predecessor auditor

A **predecessor** auditor has reported on the most recent audited statements or was engaged but did not complete an audit. Before accepting an audit, the **successor** must request **management's permission** to make inquiries of the predecessor. If management refuses, or limits the predecessor's response, the successor should consider the implications for acceptance.

Required inquiries before acceptance

Inquiry topic	Why it matters
Information that might bear on the **integrity of management**	Dishonest management is the biggest risk to an audit
Disagreements with management about accounting principles, procedures or other significant matters	Signals opinion shopping
Communications to those charged with governance about fraud, noncompliance with laws, and internal control matters	
Communications to management and TCWG about **significant deficiencies and material weaknesses**	
The predecessor's understanding of the **reasons for the change** in auditors	
Identified or suspected **fraud** and **noncompliance** with laws (SAS No. 147 made this explicit)	

The predecessor should respond **promptly and fully**, unless there are unusual circumstances such as litigation. If the response is limited, the predecessor must say so.

After acceptance

The successor may ask to **review the predecessor's working papers**. This is **not required**, and the predecessor decides which papers to make available — usually after obtaining a consent and acknowledgment letter from the client and the successor. The successor uses the review to help gather evidence on opening balances and consistency, but **may not refer to the predecessor's work** in the report as a basis for its own opinion.

If the successor later discovers that the prior-year statements audited by the predecessor may be materially misstated, the successor asks management to inform the predecessor and arrange a meeting of the three parties.

> **Exam tip:** Inquiries of the predecessor are required **before acceptance**; review of the predecessor's working papers is **optional** and happens **after acceptance**. The exam often reverses the two.

The engagement letter

The auditor agrees the terms of the engagement with management **in writing**, normally in an engagement letter.

Required elements	Commonly included (not required)
Objective and scope of the audit	Fees and billing arrangements
Responsibilities of the auditor	Planning and performance arrangements, including team composition
Responsibilities of management (the preconditions above)	Expectation of receiving a written representation letter
Statement of the **inherent limitations** of an audit and of internal control	Arrangements regarding the predecessor auditor
Identification of the **applicable financial reporting framework**	Agreement to make draft statements and other information available on time
Reference to the **expected form and content of the report**, and a statement that the form may differ depending on findings	Restrictions on the auditor's liability (where allowed)

> **Watch out:** Fees are commonly in the engagement letter, but they are **not a required element**. Neither is the name of the engagement team.

Recurring audits

On a recurring audit, the auditor assesses whether circumstances require revising the terms — for example, a change in ownership, a change in senior management, a significant change in the nature or size of the business, or new legal requirements. A new letter is not required every year if nothing has changed, though many firms issue one.

Request to change the engagement

If a client asks to change an audit to a review or compilation before completion, the auditor considers the reason:

Reason	Acceptable?
Change in the client's circumstances affecting the need for the service (for example, a bank no longer requires an audit)	Generally **acceptable**
Misunderstanding of the nature of the service originally requested	Generally **acceptable**
A **restriction on scope** imposed by management or circumstances	**Not reasonable** if it is to avoid a modified opinion — especially if management refuses to let the auditor confirm receivables, or refuses to sign a representation letter

If the auditor agrees to change, the new report should **not refer** to the original engagement, the procedures performed or any scope limitation.

Planning the audit

Planning is **not a discrete phase** that ends when fieldwork begins. It is a continual and iterative process that starts after the previous audit and runs until the current audit is complete.

Overall audit strategy versus audit plan

	Overall audit strategy	Audit plan
Purpose	Sets the **scope, timing and direction** of the audit	Sets the **nature, timing and extent** of planned procedures
Level	High level	Detailed
Content	Characteristics of the engagement (framework, industry reporting, locations), reporting objectives and timing, significant factors (materiality, high-risk areas), resources to be used	Planned risk assessment procedures; planned further audit procedures at the assertion level; other procedures required by GAAS
Order	Developed first	Developed from the strategy

Both are documented and updated as the audit progresses.

Planning activities

- Determining **materiality** for the statements as a whole and performance materiality (Chapter 7).

- Performing **risk assessment procedures** and holding the **engagement team discussion** about susceptibility to material misstatement, including fraud (Chapter 5).
- Determining the need for **specialists** (IT, valuation, tax, actuaries) and for using internal audit (Chapter 13).
- Planning the **direction, supervision and review** of team members.
- Considering **initial audit** matters: opening balances, predecessor communications, and consistency of accounting policies.

Opening balances on an initial audit

The auditor must obtain sufficient appropriate evidence that opening balances do not contain misstatements that materially affect the current statements, and that accounting policies have been consistently applied. Procedures include reviewing the predecessor's working papers, evaluating whether current-period procedures provide evidence about opening balances (collection of opening receivables, payment of opening payables), and performing specific procedures (for example, inventory roll-back).

If the auditor cannot obtain evidence about opening balances, the result is a **qualified opinion or disclaimer** (on results of operations and cash flows, often with an unmodified opinion on the balance sheet).

Communicating with those charged with governance

Those charged with governance (TCWG) — the board of directors or the audit committee — oversee the entity's strategic direction and its accountability. The auditor communicates with them throughout the audit (AU-C 260; PCAOB AS 1301 for issuers).

Matter	Timing
Auditor's **responsibilities** under GAAS	Early, often in the engagement letter
Planned scope and timing of the audit, including significant risks	During planning
Significant findings: qualitative aspects of accounting practices (policies, estimates, disclosures); significant **difficulties** encountered; **disagreements with management**; **uncorrected misstatements** and material corrected misstatements; significant matters discussed with management; written representations requested; other significant matters	Timely — before the report is released
Independence (issuers, under PCAOB Rule 3526)	Before acceptance and at least annually

Communications may be **oral or written**, except that significant findings must be in **writing** if the auditor judges that oral communication would not be adequate, and certain matters (significant deficiencies and material weaknesses — Chapter 6) must be in writing.

Exam tip: A **disagreement with management** is communicated to TCWG **whether or not it was resolved**. Difficulties in performing the audit (delays, unavailable personnel, unreasonable time pressure) are also communicated.

Worked examples

Example: Predecessor refuses to talk. Kwame, a CPA, is asked to audit Cobalt Ridge Mining. Management gives permission to contact the predecessor, but the predecessor responds only that "due to pending litigation, we will not comment."

- The predecessor must indicate that its response is limited — it has done so.
- Kwame must consider the **implications** for acceptance: litigation between client and predecessor may signal management integrity issues.
- Kwame may still accept, but should perform other procedures on management's integrity (inquiries of bankers and attorneys, background checks) and document his conclusion. If management had **refused permission** to contact the predecessor, that refusal is itself a red flag.

Example: Change from audit to review. Midway through the audit of Eastgate Textiles, the CFO refuses to allow confirmation of receivables and asks the auditor to perform a review instead "to save time."

- The request follows a **restriction on scope** imposed by management.
- A change would avoid a modified opinion — not a reasonable basis.
- The auditor should **not** agree to the change. The auditor continues the audit and evaluates the scope limitation (likely a qualified opinion or disclaimer — Chapter 15), or withdraws.

Example: Strategy or plan? Classify each decision.

1. "We will use the firm's IT specialists for the new ERP system and perform interim work in October." — **Overall audit strategy** (direction, resources and timing).
2. "Confirm all receivables over $50,000 and a random sample of 40 others as of year-end." — **Audit plan** (nature, timing and extent of a further procedure).
3. "Materiality is $240,000 and revenue recognition is a significant risk." — **Overall audit strategy** (significant factors).

Common traps

- Believing fees are a required engagement-letter element.
- Thinking planning ends when fieldwork begins.
- Treating review of the predecessor's working papers as required before acceptance.
- Accepting a change to a review requested to avoid a scope limitation, or referring to the abandoned audit in the review report.
- Thinking resolved disagreements need not be communicated to TCWG.

Key takeaways

- Preconditions: acceptable framework and management's acknowledgment of its responsibilities. If absent, do not accept.
- Do not accept if management imposes a scope limitation that would lead to a disclaimer.
- Predecessor inquiries (with client permission) before acceptance: integrity, disagreements, communications on fraud, noncompliance and control deficiencies, reasons for change.
- Engagement letter: objective and scope, responsibilities of auditor and management, inherent limitations, framework, expected report.
- Strategy = scope, timing, direction; plan = nature, timing, extent of procedures. Planning is continual.
- Communicate with TCWG: responsibilities, planned scope and timing, significant findings (including resolved disagreements, difficulties and uncorrected misstatements).

5. Risk Assessment, Fraud & Laws

Risk assessment is the engine of a modern audit. The auditor first understands the entity and identifies where the financial statements could be materially misstated, and only then decides what to test. SAS No. 145 (AU-C 315) governs risk assessment for nonissuers; AU-C 240 covers fraud; AU-C 250 covers laws and regulations. PCAOB AS 2110, AS 2401 and AS 2405 are the issuer counterparts. This chapter is one of the most heavily tested in AUD.

Risk of material misstatement

The **risk of material misstatement (RMM)** is the risk that the statements are materially misstated before the audit. It exists at two levels:

- **Financial statement level** — risks that relate pervasively to the statements as a whole (for example, weak tone at the top, a going concern problem, management override). These are addressed with **overall responses**.
- **Relevant assertion level** — risks tied to specific classes of transactions, account balances and disclosures. These are addressed with **further audit procedures**.

At the assertion level, RMM has two components that SAS No. 145 requires the auditor to assess **separately**:

Component	Definition	Who controls it
Inherent risk (IR)	Susceptibility of an assertion to misstatement **before** considering any related controls	Neither — the auditor assesses it
Control risk (CR)	Risk that a misstatement will not be prevented, or detected and corrected, on a timely basis by the entity's internal control	Neither — the auditor assesses it

Watch out: Under SAS No. 145, inherent risk and control risk are **assessed separately** for each relevant assertion. An answer that "combines them into one assessment" for nonissuer audits is wrong.

The spectrum of inherent risk

Inherent risk is not "high" or "low"; it falls on a **spectrum**. Where a risk falls depends on the **likelihood** of misstatement and the **magnitude** of potential misstatement. The **inherent risk factors** push risks up the spectrum:

Inherent risk factor	Example
Complexity	Revenue from multi-element software contracts
Subjectivity	Fair value of a level 3 investment
Change	A new ERP system, a new line of business, new accounting standards
Uncertainty	Litigation reserves, warranty estimates with little history
Susceptibility to misstatement due to management bias or fraud	Bonus tied to earnings targets; estimates management can steer

A **significant risk** is an identified RMM for which the assessment of inherent risk is **close to the upper end of the spectrum**, or one that must be treated as significant under GAAS (for example, fraud risks). Significant risks require:

- understanding the related controls (design and implementation),
- **substantive procedures specifically responsive** to the risk — if only substantive procedures are used, they must include **tests of details**, and
- testing the relevant controls in the **current year** if the auditor plans to rely on them.

Control risk

The auditor must evaluate the design of certain controls and whether they are implemented. However, unless the auditor **plans to test the operating effectiveness** of controls, **control risk is assessed at the maximum** — so RMM equals inherent risk.

Risk assessment procedures

Risk assessment procedures provide the basis for identifying and assessing RMM. They are:

Procedure	Example
Inquiries of management, internal audit, others (in-house legal, sales, IT, employees at different levels)	Asking the sales manager about changes in customer terms
Analytical procedures	Comparing gross margin by product line with last year and the budget
Observation	Watching the receiving dock process shipments
Inspection	Reading board minutes, business plans, contracts and internal control manuals

Risk assessment procedures **alone** do not provide sufficient appropriate evidence on which to base the opinion. They tell you where to look.

Understanding the entity and its environment

The auditor obtains an understanding of:

1. The **entity and its environment** — organizational structure, ownership, governance, business model (including IT), industry, regulatory and other external factors, and measures used to assess financial performance.
2. The **applicable financial reporting framework** and the entity's accounting policies.
3. The **system of internal control** — all five COSO components (Chapter 6), including the entity's **use of IT** and general IT controls.

Engagement team discussion

The engagement partner and key team members discuss the application of the framework and the **susceptibility of the statements to material misstatement**, including how and where fraud might occur. This discussion should emphasize **professional skepticism** and set aside beliefs that management is honest.

Fraud (AU-C 240)

Fraud is an intentional act that results in a material misstatement. Error is unintentional. The auditor's concern is two types of fraud:

Type	Description	Examples
Fraudulent financial reporting	Intentional misstatements or omissions in the statements to deceive users	Fictitious revenue, improper cutoff, hiding liabilities, biased estimates
Misappropriation of assets	Theft of the entity's assets, often with false records to hide it	Embezzling receipts (lapping), payments to fictitious vendors, stealing inventory

The fraud triangle

Element	Fraudulent reporting example	Misappropriation example
Incentive / pressure	Bonuses tied to earnings; debt covenants; analyst expectations	Personal financial difficulty
Opportunity	Significant related-party transactions; complex estimates; ineffective board oversight	Poor segregation of duties; large cash on hand; weak physical controls
Attitude / rationalization	Aggressive accounting; management disregard for controls; prior violations	"I'll pay it back"; disgruntled employees

> **Memory trick:** "**I O A**" — Incentive, Opportunity, Attitude. Opportunity is the element that internal controls most directly affect.

Required fraud procedures

- **Brainstorming** (part of the team discussion) about where the statements are susceptible to fraud.
- **Inquiries** of management, those charged with governance, internal audit and others about fraud risks and known or suspected fraud.
- Considering **unusual or unexpected relationships** from analytical procedures (including revenue).
- Considering **fraud risk factors** (the triangle).

Presumed fraud risks

Presumption	Can it be rebutted?
Revenue recognition is a fraud risk	**Yes** — the auditor may conclude it does not apply (for example, a single simple revenue stream such as rental income from one tenant) and must **document** the reasons
Management override of controls is a fraud risk	**No** — present in every entity

Responses to the risk of management override

Regardless of the assessment, the auditor must:

1. **Test journal entries** and other adjustments — including entries made at the end of the reporting period, by unusual users, to unusual accounts, with round numbers or with little or no description.
2. **Review accounting estimates for bias**, including a **retrospective review** of prior-year estimates compared with actual outcomes.
3. Evaluate the **business rationale** for **significant unusual transactions** outside the normal course of business.

Responses to other fraud risks include overall responses (assigning more experienced staff, adding **unpredictability** — surprise counts, untested locations), and changing the nature, timing and extent of procedures (more year-end testing, larger samples, confirmations of contract terms).

Communicating fraud

- **Any** evidence that fraud may exist: bring to the attention of the appropriate level of management (at least one level above those involved).

- Fraud involving **senior management**, or fraud by employees with significant roles in internal control, or fraud causing a material misstatement: communicate to **those charged with governance**.
- Disclosure **outside the entity** is generally **not** the auditor's responsibility and confidentiality may prevent it, except: to respond to a **subpoena**, to a **successor auditor** inquiring under the standards (with permission), to a **funding agency** under government audit requirements, and as required by law (for example, the Private Securities Litigation Reform Act / Section 10A for issuers).

Laws and regulations (AU-C 250)

Category	Auditor's responsibility
Laws with a **direct effect** on the determination of material amounts and disclosures (tax laws, pension laws)	Obtain **sufficient appropriate evidence** about compliance
Other laws that may have a material effect (occupational safety, environmental, licensing)	Perform specified procedures to help identify noncompliance: **inquiry** of management and TCWG, and **inspection of correspondence** with licensing or regulatory authorities

When the auditor becomes aware of **suspected noncompliance**, the auditor obtains an understanding of the act, evaluates the possible effect on the statements, discusses it with management (and TCWG), and considers legal advice. Noncompliance is communicated to TCWG (unless clearly inconsequential). If management does not take appropriate remedial action, the auditor considers **withdrawal**.

For issuers, **Section 10A** of the Securities Exchange Act requires the auditor to report an illegal act with a material effect to the board if management does not take remedial action; the board must notify the **SEC within one business day**, and if it does not, the auditor must furnish the report to the SEC (or resign) by the end of the next business day.

Worked examples

Example: Placing risks on the spectrum. Delmar Freight has three areas:

- Cash — one bank, simple reconciliations, no estimates. Inherent risk factors: none significant → **low** on the spectrum.
- Fuel expense — high volume, routine, but fuel prices changed sharply → **moderate** (change factor).
- Self-insurance reserve for accident claims — actuarial estimate, uncertain outcomes, management's bonus is based on operating income → **near the upper end** (uncertainty, subjectivity, susceptibility to bias). Treat as a **significant risk**: understand the controls, perform tests of details responsive to the risk, and test controls this year if relying on them.

Example: Rebutting the revenue presumption. Hana audits a holding company whose only revenue is fixed monthly rent from one related tenant under a long-term lease.

- The revenue stream is simple, one contract, fixed amounts, no judgment.
- Hana may **rebut** the presumption that revenue recognition is a fraud risk and must **document** why.
- She may **not** rebut the risk of management override; journal entry testing, the review of estimates and evaluation of unusual transactions are still required.

Example: Classifying fraud red flags. For each fact, name the triangle element.

1. The CEO's bonus doubles if earnings beat analyst forecasts. **Incentive/pressure.**
2. One employee opens mail, records receipts and reconciles the bank account. **Opportunity.**
3. The CFO has repeatedly argued for aggressive estimates and says "everyone does it." **Attitude/rationalization.**

Common traps

- Combining inherent and control risk into a single assessment under SAS No. 145.
- Assuming large size alone makes a risk significant — significance depends on inherent risk factors, likelihood and magnitude.
- Thinking risk assessment procedures provide enough evidence for the opinion.
- Believing the management override risk can be rebutted.
- Assuming the auditor must report suspected fraud directly to authorities in every case.

Key takeaways

- RMM = IR and CR, assessed separately at the assertion level; CR is at maximum unless controls will be tested.
- Inherent risk factors: complexity, subjectivity, change, uncertainty, susceptibility to bias or fraud. Risks near the top of the spectrum are significant risks.
- Risk assessment procedures: inquiry, analytical procedures, observation, inspection.
- Fraud triangle: incentive/pressure, opportunity, attitude/rationalization. Revenue presumption rebuttable; management override never.
- Override responses: journal entries, retrospective review of estimates, unusual transactions.
- Laws: direct-effect laws need sufficient appropriate evidence; others need inquiry and inspection of regulator correspondence.

6. Internal Control & Tests of Controls

Internal control is the set of processes that management and the board put in place to achieve reliable reporting, effective operations and compliance. The auditor must understand it on every audit, may rely on it to reduce substantive work, and must communicate its significant weaknesses. For issuers, the auditor also gives an opinion on it. This chapter covers the COSO framework, transaction cycles and segregation of duties, IT controls, tests of controls, deficiency evaluation and the integrated audit.

The COSO framework

The **2013 COSO Internal Control — Integrated Framework** defines internal control as a process, effected by the board, management and other personnel, designed to provide **reasonable assurance** about objectives in three categories: **operations, reporting and compliance**.

Component	What it includes	Examples
Control environment	Integrity and ethical values, board independence and oversight, structure and authority, commitment to competence, accountability	Code of conduct, independent audit committee, hiring and training policies
Risk assessment	Identifying and analyzing risks to objectives, including fraud risk and significant changes	Annual enterprise risk review, analysis of new regulations
Control activities	Policies and procedures that carry out management's responses to risk, including general IT controls	Approvals, reconciliations, segregation of duties, physical controls, access controls
Information and communication	Relevant, quality information; internal and external communication	Accounting system, whistleblower hotline, policy manuals
Monitoring activities	Ongoing and separate evaluations; communicating deficiencies	Internal audit, management review of KPIs, supervisory review

The framework has **17 principles** supporting the five components (5 for the control environment, 4 risk assessment, 3 control activities, 3 information and communication, 2 monitoring).

Memory trick: "**C-R-I-M-E**" — Control environment, Risk assessment, control activities, Information and communication, Monitoring. The control environment is the foundation for all the others.

Inherent limitations

Internal control provides **reasonable, not absolute**, assurance because of human judgment errors, breakdowns (misunderstanding, carelessness), **collusion** among two or more people, **management override**, and cost-benefit constraints.

Controls by type

Classification	Meaning	Example
Preventive	Stops a misstatement before it happens	Requiring approval before a purchase order is issued; system edit checks
Detective	Finds a misstatement after it happens, for correction	Bank reconciliation; review of exception reports
Manual	Performed by people	Supervisor signs a timesheet
Automated (application)	Performed by the system	Three-way match in the ERP; credit-limit check
General IT controls (GITCs)	Support the continued functioning of application controls	Access security, program change management, IT operations

Segregation of duties

The classic rule: separate **authorization** of transactions, **recording** of transactions, and **custody** of the related assets. (Many textbooks add reconciliation/verification as a fourth duty.)

Combination to avoid	Fraud it enables
Receiving cash **and** posting to customer accounts	**Lapping** — stealing one customer's payment and covering it with the next customer's
Approving vendors **and** approving payments	Payments to fictitious vendors
Preparing payroll **and** distributing paychecks	Ghost employees
Writing checks **and** reconciling the bank account	Concealing unauthorized disbursements
Custody of inventory **and** recording inventory	Theft concealed by adjusting records

> **Memory trick:** "**ARC**" — Authorization, Recording, Custody. No one person should hold two letters of the same transaction.

Key controls by cycle

Cycle	Key documents and controls
Revenue (sales, receivables, receipts)	Customer order → credit approval → shipping document (bill of lading) → sales invoice → posting; prenumbered documents accounted for; lockbox; remittance advice separated from checks; monthly statements sent by someone independent of receivables
Purchasing (purchases, payables, disbursements)	Purchase requisition → purchase order (approved) → receiving report (blind count) → vendor invoice → **three-way match** → voucher → check signed by authorized signer who cancels supporting documents
Payroll	Personnel authorizes hiring and pay rates; timekeeping approves hours; payroll prepares; treasurer signs; paymaster distributes; imprest payroll bank account
Inventory and production	Perpetual records, periodic counts, restricted warehouse access, standard costing variance review
Financing and investing	Board authorization of debt, equity and major acquisitions; custodians; independent registrar and transfer agent

IT and internal control

SAS No. 145 requires the auditor to understand the entity's **IT environment** and to identify **risks arising from the use of IT** and the related **general IT controls**, for IT applications that are subject to risks the auditor must address.

General IT control area	Examples
Access to programs and data	User authentication, role-based access, periodic access reviews, privileged-user monitoring
Program changes	Change requests approved, testing in a separate environment, migration by someone other than the developer
Program development / acquisition	Project approval, user acceptance testing, data conversion controls
Computer operations	Job scheduling, backup and recovery, incident management

Application controls include **input** controls (edit and validity checks, field checks, limit and reasonableness tests, check digits), **processing** controls (control totals, record counts, hash totals, run-to-run totals) and **output** controls (review and distribution of reports).

> **Exam tip:** If general IT controls are weak, the auditor cannot rely on automated application controls without additional testing, because the program may have been changed or bypassed.

Understanding and testing controls

Design and implementation versus operating effectiveness

Evaluation	Question	When required	Procedures
Design and implementation	Is the control capable of preventing or detecting a misstatement, and does it exist and is it being used?	For controls that address significant risks, controls over journal entries, controls the auditor plans to test, other controls the auditor judges appropriate, and GITCs for those	Inquiry **plus** observation, inspection, or a **walkthrough**
Operating effectiveness	Did the control operate consistently throughout the period, and by whom and how?	When the auditor plans to rely on the control, or when substantive procedures alone cannot provide sufficient evidence	Inquiry **plus** observation, inspection, **reperformance**

A **walkthrough** follows a transaction from origination through the entity's processes until it is reflected in the financial records, using the same documents and IT the entity's personnel use.

Watch out: Inquiry alone is never sufficient to test operating effectiveness. Observation applies only at the moment observed. **Reperformance** provides the strongest evidence.

Timing of tests of controls

- Controls tested at an **interim date** need additional evidence for the **remaining period** (inquiry about changes, extending tests, testing monitoring controls).
- Evidence from **prior audits** can be used for controls that have **not changed**, but the auditor must test such controls **at least once every third audit**, and test some controls each year.
- Controls over **significant risks** must be tested in the **current period** if the auditor relies on them.

Effect on the audit

Result of tests of controls	Assessed control risk	Substantive procedures
Controls operate effectively	Lower	Less extensive, may be performed at interim, less effective types acceptable
Deviations found, controls not effective	Higher (up to maximum)	More extensive, closer to year-end, more effective types

Even with effective controls, the auditor must perform **substantive procedures for every material** class of transactions, account balance and disclosure.

Evaluating deficiencies (AU-C 265)

Term	Definition (plain words)
Deficiency in internal control	A control's design or operation does not allow management or employees, in the normal course of their duties, to prevent, or detect and correct, misstatements on a timely basis
Significant deficiency	A deficiency, or combination, **less severe than a material weakness** but important enough to merit the attention of those charged with governance
Material weakness	A deficiency, or combination, such that there is a **reasonable possibility** that a **material misstatement** will not be prevented, or detected and corrected, on a timely basis

Severity depends on the **likelihood** (reasonable possibility) and **magnitude** of potential misstatement — **not** on whether a misstatement actually occurred.

Indicators of a material weakness include: fraud by senior management (material or not), restatement of previously issued statements to correct a material misstatement, the auditor identifying a material misstatement that the entity's controls would not have detected, and ineffective oversight by those charged with governance.

Communication

- **Significant deficiencies and material weaknesses** must be communicated **in writing** to management and those charged with governance, ideally by the report release date and **no later than 60 days after the report release date**.
- Other deficiencies are communicated to management (orally or in writing) when they merit management's attention.
- The written communication describes the deficiencies, explains their potential effects, and states that the audit was not designed to express an opinion on internal control. It should **not** state that no significant deficiencies were found (a "no material weakness" statement is allowed only for certain government purposes and must be worded carefully).

The integrated audit for issuers (AS 2201)

For larger issuers (accelerated and large accelerated filers), Section 404(b) of Sarbanes-Oxley requires an audit of **internal control over financial reporting (ICFR)** integrated with the financial statement audit.

Feature	AS 2201
Approach	**Top-down**: start at the financial statement level and entity-level controls, then significant accounts, disclosures and relevant assertions, then the controls that address them
Date of assessment	ICFR is evaluated **as of year-end** (the date of management's assessment)
Walkthroughs	Used to understand flows and to evaluate design
Rotating tests	Not allowed — each year's opinion is based on that year's testing (with knowledge from prior years affecting the extent)
Opinion if a **material weakness** exists	**Adverse** opinion on ICFR — never qualified
Reports	Combined or separate reports; if separate, both reports are **dated the same date** and each refers to the other
Using the work of others	Allowed, based on competence and objectivity

Watch out: A material weakness leads to an **adverse** ICFR opinion. A qualified ICFR opinion does not exist for a material weakness. A **scope limitation** leads to a disclaimer or withdrawal.

Nonissuers may also engage the auditor to examine ICFR under the SSAEs (AT-C 205, integrated with the audit), using the same definitions.

Worked examples

Example: Severity of a deficiency. At Brightwater Clinics, no one reviews the monthly reconciliation of patient receivables. No misstatement has been found. Receivables are material and the reconciliation is the only control that would detect billing errors.

- Likelihood: there is a **reasonable possibility** that an error would go undetected, because no compensating control exists.
- Magnitude: receivables are material, so a potential misstatement could be material.
- Conclusion: **material weakness**, even though no misstatement occurred. Communicate in writing to management and TCWG within 60 days after the report release date. For an issuer, the ICFR opinion would be **adverse**.

Example: Choosing a test of a control. The control: the purchasing manager approves every purchase order over $5,000 in the system before it is sent.

- Inquiry of the manager: not sufficient alone.
- Inspection of a sample of POs over $5,000 for approval evidence (system log): tests operating effectiveness.
- Reperformance: try to release an unapproved $6,000 PO in a test environment (or inspect the system configuration and change log) — strongest evidence for an automated control, combined with tests of GITCs.

Example: Segregation of duties. An accounts receivable clerk also opens the mail and deposits checks. Identify the risk and a fix.

- Risk: **lapping** — the clerk takes Customer A's payment, then credits A with Customer B's later payment, and so on.
- Fix: have someone independent open mail and prepare a remittance list (or use a lockbox); have a separate person post to customer accounts and another reconcile deposits with postings.

Common traps

- Concluding a deficiency is minor because no misstatement occurred.
- Confusing preventive (before) with detective (after) controls.
- Believing a material weakness gives a qualified ICFR opinion.
- Using inquiry alone to test operating effectiveness.
- Mixing up COSO's five components with SQMS No. 1's eight.

Key takeaways

- COSO: five components (C-R-I-M-E), 17 principles, reasonable assurance; limitations include collusion and management override.
- Segregate authorization, recording and custody.
- Design and implementation: inquiry plus other procedures; operating effectiveness: inquiry plus inspection, observation, reperformance.
- Unchanged controls tested at least every third audit; controls over significant risks every year if relied on.
- Deficiency → significant deficiency → material weakness (reasonable possibility of material misstatement). Written communication within 60 days after report release.
- AS 2201: top-down, as of year-end, any material weakness = adverse ICFR opinion, reports dated the same day.

7. Materiality & Audit Risk

Materiality and audit risk are the two dials the auditor sets to decide how much work is enough. Materiality tells the auditor what size of misstatement matters to users; audit risk tells the auditor how much uncertainty is acceptable. Together they drive sample sizes, the nature of procedures and the evaluation of misstatements. AUD tests both the concepts and the computations.

Materiality

Misstatements, including omissions, are **material** if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a **reasonable user** based on the financial statements. Materiality is a matter of professional judgment, considering both **amount (quantitative)** and **nature (qualitative)**.

Levels of materiality

Level	Purpose	Typical setting
Materiality for the financial statements as a whole (overall materiality)	The largest misstatement that would not influence users	A percentage of a benchmark (see below)
Materiality for particular items (specific materiality)	Lower amounts for classes, balances or disclosures where smaller misstatements would influence users	Related-party transactions, executive compensation, a key ratio in a covenant
Performance materiality	Set **below** overall materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality	Often 50%–75% of overall materiality (judgment)
Tolerable misstatement	Performance materiality applied to a particular sampling procedure	Usually **at or below** performance materiality
Clearly trivial threshold	Misstatements below this are not accumulated	A small percentage of overall materiality (often around 3–5%)

Common benchmarks

The standards do not set percentages. The figures below are common practice rules of thumb, and the exam gives you the percentage it wants.

Entity type	Common benchmark	Typical range
Profit-oriented, stable earnings	Pretax income from continuing operations	About **5%**
Profit-oriented, volatile or near-breakeven earnings	Revenue or total assets	About **0.5%–1%** (revenue), **0.5%–1%** (assets)
Not-for-profit	Total revenue or total expenses	0.5%–2%
Asset-based entity (investment fund)	Net assets	About 1%

Qualitative materiality

A quantitatively small misstatement may be material because of its **nature**:

- It turns a loss into a profit, or a profit into a loss.
- It causes noncompliance with a **debt covenant** or regulatory requirement.
- It changes a trend in earnings or meets analyst expectations.
- It increases management's compensation.
- It involves **fraud** or an illegal act.
- It concerns a segment or portion of the business that is significant to users.

Revising materiality

Materiality is revised during the audit when the auditor learns information that would have caused a different amount initially — most often when **actual results differ significantly** from the planning figures. Before evaluating uncorrected misstatements, the auditor **reassesses materiality using actual results**.

Example: Setting materiality. Alder Creek Foods expects pretax income of $4,800,000. The auditor uses 5% for overall materiality, 75% of overall materiality for performance materiality and 5% of overall materiality as the clearly trivial threshold.

- Overall materiality = $4,800,000 × 5% = **$240,000**.
- Performance materiality = $240,000 × 75% = **$180,000**.
- Clearly trivial = $240,000 × 5% = **$12,000**. Misstatements below $12,000 are not accumulated.

If pretax income were volatile and the auditor used revenue of $62,000,000 instead, a 0.5%–1% range gives **$310,000 to $620,000**.

Audit risk

Audit risk (AR) is the risk that the auditor expresses an inappropriate opinion when the statements are materially misstated. It is a function of the risk of material misstatement and **detection risk**:

AR = RMM × DR = IR × CR × DR

Component	Definition	Auditor controls it?
Inherent risk (IR)	Susceptibility of an assertion to misstatement before controls	No — assessed
Control risk (CR)	Risk that controls won't prevent, or detect and correct, a misstatement	No — assessed
Detection risk (DR)	Risk that the auditor's procedures will not detect a material misstatement	**Yes** — through the nature, timing and extent of substantive procedures

Rearranging gives the acceptable level of detection risk:

DR = AR ÷ (IR × CR)

If assessed RMM is...	Acceptable DR is...	So the auditor...
Higher	**Lower**	Obtains more and better evidence: more effective procedures (tests of details, external evidence), performed at year-end, larger samples
Lower	**Higher**	May use less persuasive procedures, interim testing, smaller samples

Detection risk has two parts: **sampling risk** (the sample may not represent the population) and **nonsampling risk** (applying the wrong procedure, misreading evidence). Detection risk can be reduced but never eliminated.

> **Memory trick:** RMM and detection risk move **opposite** ways. "High risk in, low risk allowed out."

Example: Computing acceptable detection risk. The auditor wants audit risk of 5%. For inventory existence, inherent risk is 80% and control risk is 50%.

- IR × CR = 0.80 × 0.50 = 0.40.
- DR = 0.05 ÷ 0.40 = **0.125, or 12.5%**.

If the auditor does not test controls, control risk is at maximum (100%):

- DR = 0.05 ÷ (0.80 × 1.00) = **0.0625, or 6.25%** — half as much detection risk allowed, so substantive testing must be more extensive.

For a lower-risk assertion with IR 50% and CR 40%: DR = 0.05 ÷ 0.20 = **25%**.

Watch out: Do not multiply all three to find DR. You **divide** audit risk by the product of inherent and control risk.

Types of misstatements

The auditor **accumulates** misstatements identified during the audit, other than those that are clearly trivial.

Type	Meaning	Example
Factual	No doubt about it	An invoice recorded twice
Judgmental	Difference between management's estimate and the auditor's view, or an inappropriate policy choice	Warranty reserve of $210,000 when the auditor's reasonable range is $260,000–$300,000
Projected	Auditor's best estimate in a population from a sample	Sample errors extrapolated to the whole receivables population

For a judgmental misstatement where the auditor develops a **range**, the misstatement is the difference between management's estimate and the **nearest end** of the range. In the warranty example, the misstatement is $260,000 − $210,000 = $50,000 understatement.

Evaluating misstatements

1. Communicate all accumulated misstatements to the appropriate level of management on a timely basis and **request correction**.
2. If management refuses, understand its reasons.
3. **Reassess materiality** using actual results.
4. Evaluate whether **uncorrected misstatements** are material, individually or in aggregate, considering size, nature, the particular circumstances and the effect of **prior-period** uncorrected misstatements.

5. Communicate uncorrected misstatements to **those charged with governance** and obtain a **written representation** that management believes their effects are immaterial (with a summary attached to or included in the representation letter).
6. Consider the effect on the opinion (Chapter 15).

Misstatements are combined with regard to **direction** — overstatements and understatements of income may offset in the total, but the auditor also considers whether individual misstatements are material by themselves or by nature, and whether offsetting is appropriate (for example, misstatements in different accounts may each matter).

Example: Evaluating uncorrected misstatements. Overall materiality (reassessed on actual results) is $240,000. Uncorrected misstatements effect on pretax income:

Item	Effect on pretax income
Unrecorded liability for utilities (expense omitted)	Overstates income by $95,000
Projected misstatement in receivables (overstated revenue)	Overstates income by $120,000
Depreciation overstated (wrong life)	Understates income by $30,000

- Net effect = $95,000 + $120,000 − $30,000 = **$185,000 overstatement**.
- $185,000 is below $240,000, so the aggregate is not material quantitatively.
- But the gross overstatements total $215,000, close to materiality, and **undetected** misstatements may exist. The auditor should consider requesting correction, performing additional procedures, and whether any item is qualitatively material (for example, a covenant based on income).

Materiality in different contexts

Context	Note
Group audits	Component materiality is set lower than group materiality
ICFR (AS 2201)	Uses the same materiality as the financial statement audit
Single audits	Materiality is determined for each **major program** (Chapter 18)
Reviews (SSARS)	The accountant also uses materiality to design procedures and evaluate findings

Common traps

- Multiplying AR × IR × CR to get DR instead of dividing.
- Adding misstatements without regard to direction, or ignoring prior-year uncorrected misstatements.
- Confusing performance materiality (lower, for planning) with overall materiality.

- Treating materiality as purely quantitative — a small fraud or a covenant violation can be material.
- Measuring a judgmental misstatement to the midpoint of the auditor's range instead of the nearest end.

Key takeaways

- Overall materiality from a benchmark (about 5% of pretax income; 0.5–1% of revenue or assets); performance materiality lower; tolerable misstatement ≤ performance materiality; clearly trivial amounts not accumulated.
- AR = IR × CR × DR; DR = AR ÷ (IR × CR). Higher RMM → lower DR → more, better, later evidence.
- The auditor controls only detection risk.
- Misstatements: factual, judgmental, projected. Reassess materiality on actual results; obtain a representation on uncorrected misstatements; communicate them to TCWG.

8. Audit Evidence & Responses to Risk

Once risks are assessed, the auditor designs **further audit procedures** to respond to them and gathers **audit evidence** to support the opinion. This chapter covers what makes evidence sufficient and appropriate, financial statement assertions, the types of procedures, external confirmations, accounting estimates, related parties, litigation and audit documentation. It is the bridge between risk assessment (Chapters 5–7) and the account areas (Chapters 10–11).

Sufficient appropriate audit evidence

Audit evidence is information used by the auditor in arriving at the conclusions on which the opinion is based (SAS No. 142, AU-C 500). It must be:

- **Sufficient** — the **quantity** of evidence. More is needed when RMM is higher; less when the evidence is of higher quality.
- **Appropriate** — the **quality** of evidence: **relevance** (does it address the assertion?) and **reliability** (can it be trusted?).

SAS No. 142 asks the auditor to evaluate evidence based on its **attributes**: relevance, reliability, and whether it **corroborates or contradicts** management's assertions, and it emphasizes the use of **audit data analytics** and **professional skepticism** in evaluating information, including information produced by the entity.

Reliability hierarchy

More reliable	Less reliable
Obtained from **independent sources outside** the entity (bank confirmations, vendor statements)	Obtained from inside the entity
Generated internally when **controls are effective**	Generated internally when controls are weak
Obtained **directly by the auditor** (observation, recalculation, reperformance)	Obtained indirectly or by inference (inquiry)
Documentary, paper or electronic	Oral
Original documents	Photocopies, faxes, scans (unless authenticity is confirmed)

When information produced by the entity (IPE) is used as evidence, the auditor evaluates whether it is **accurate and complete** and sufficiently precise and detailed.

Exam tip: Inquiry alone never provides sufficient appropriate evidence for a relevant assertion. It must be corroborated.

Assertions

Assertions are management's representations, explicit or implied, about recognition, measurement, presentation and disclosure. The auditor uses them to identify risks and design procedures.

Assertion	Classes of transactions (income statement)	Account balances (balance sheet)
Occurrence / Existence	Recorded transactions **occurred** and pertain to the entity	Assets, liabilities and equity **exist**
Completeness	All transactions that should be recorded **are** recorded	All balances that should be recorded **are** recorded
Accuracy / Valuation and allocation	Amounts were recorded **accurately**	Balances are included at **appropriate amounts** (valuation adjustments recorded)
Cutoff	Transactions are recorded in the **correct period**	—
Classification	Recorded in the **proper accounts**	Recorded in the proper accounts
Rights and obligations	—	The entity **holds or controls** the rights to assets, and liabilities are its obligations
Presentation	Appropriately aggregated, described and disclosed	Same

Memory trick: "**PERCV**" for balances — Presentation, Existence, Rights and obligations, Completeness, Valuation. For transactions add **cutoff, accuracy, classification** and swap existence for **occurrence**.

Direction of testing

Procedure	Direction	Assertion tested
Vouching	From the **recorded entry** back to the **source document** (ledger → invoice/shipping document)	**Existence / occurrence** (overstatement)
Tracing	From the **source document** forward to the **recorded entry** (shipping document → sales journal)	**Completeness** (understatement)

> **Memory trick:** "**V**ouching = **V**alidity (existence); **T**racing = **T**otality (completeness)." Vouch back, trace forward.

Types of audit procedures

Procedure	Description	Example
Inspection of records or documents	Examining records or documents	Reading a lease agreement; examining invoices
Inspection of tangible assets	Physical examination	Looking at a new machine
Observation	Watching a process	Observing the inventory count
External confirmation	Direct written response from a third party	Bank and receivable confirmations
Recalculation	Checking mathematical accuracy	Recomputing depreciation
Reperformance	Independently executing a control or procedure	Reperforming the bank reconciliation
Analytical procedures	Evaluating plausible relationships	Comparing payroll expense to headcount × average pay
Inquiry	Seeking information from knowledgeable persons	Asking the controller about unusual entries

Responding to assessed risks (AU-C 330)

Overall responses to financial-statement-level risks: emphasizing professional skepticism, assigning more experienced staff or specialists, more supervision, adding **unpredictability**, and changing the general nature, timing or extent of procedures.

Further audit procedures at the assertion level are **tests of controls** and **substantive procedures** (tests of details and substantive analytical procedures). Their design depends on:

Dimension	Higher risk means...
Nature (type and purpose)	More reliable, more relevant procedures — tests of details, external confirmations, physical examination
Timing	Closer to or at the **period end**; unannounced procedures
Extent	Larger sample sizes, more locations

Required regardless of risk:

- **Substantive procedures** for **each relevant assertion** of each **material** class of transactions, account balance and disclosure.
- Agreeing the financial statements to the underlying records and examining material **journal entries and adjustments** made in preparing the statements.
- For **significant risks** addressed only by substantive procedures, those procedures must include **tests of details**.

When substantive procedures are performed at an **interim date**, the auditor must cover the **remaining period** (rollforward procedures) by combining substantive procedures with tests of controls or further substantive procedures.

External confirmations (AU-C 505)

The auditor must **maintain control** over confirmation requests: determine the information to confirm, select the parties, design the request, and **send and receive** the requests directly (management may not mail or collect them).

Form	Description	When appropriate
Positive	Recipient responds in every case — agreeing or disagreeing (may be **blank**, asking the recipient to fill in the amount)	Default; required for large balances or when RMM is higher
Negative	Recipient responds **only if it disagrees**	Only as the **sole** substantive procedure when **all** of these hold: RMM is **low** and controls are effective; population of **many small, homogeneous** balances; a **very low exception rate** expected; and no reason to believe recipients will ignore the requests

Handling results:

- **Management refuses** to allow a confirmation: ask why, evaluate the reasons and the implications for fraud risk and management integrity, perform **alternative procedures**

— and if the refusal is unreasonable or alternatives are not possible, communicate with TCWG and consider the effect on the opinion.

- **Nonresponse** to a positive request: perform **alternative procedures** (for receivables: examine **subsequent cash receipts**, shipping documents and sales invoices). Unless a response is essential, in which case failure to obtain it is a scope limitation.
- **Exceptions**: investigate; not every exception is a misstatement (timing differences such as payments in transit are common).

Receivables confirmation is **presumed** (Chapter 10) unless receivables are immaterial, confirmations would be ineffective, or assessed RMM is low and other substantive procedures address it.

Accounting estimates (SAS No. 143, AU-C 540)

Estimates (allowances, impairments, fair values, warranties) carry **estimation uncertainty**, complexity and subjectivity. The auditor's response may use one or more of three approaches:

Approach	What the auditor does
Test how management made the estimate	Evaluate the method, significant assumptions and data for appropriateness, consistency and reliability
Develop an auditor's point estimate or range	Use own model or assumptions; compare with management's estimate. Narrow the range to amounts supported by evidence
Obtain evidence from events up to the report date	Use subsequent settlements or sales to test the estimate

The auditor also evaluates **indicators of management bias** (for example, consistently choosing the end of a range that benefits earnings) and performs a **retrospective review** of prior-period estimates. A misstatement exists when management's estimate is outside the auditor's range — measured to the **nearest end** of the range.

Related parties (AU-C 550)

The auditor obtains an understanding of related-party relationships and transactions, remains alert for undisclosed related parties (when reading minutes, contracts, confirmations), and for significant related-party transactions outside the normal course of business, inspects the contracts and evaluates their **business rationale**, authorization and disclosure. If the auditor identifies a related party management did not disclose, the auditor tells the team, asks management to identify all transactions with that party, and reassesses risk.

Litigation, claims and assessments (AU-C 501)

Management is the primary source of information about litigation. The auditor:

1. **Inquires** of management and in-house counsel, reviews minutes and legal expense accounts, and examines invoices from lawyers.
2. Sends a **letter of audit inquiry** (prepared by management, sent by the auditor) to the entity's **external legal counsel**, asking them to evaluate pending or threatened litigation and the completeness of management's list.
3. Considers a **lawyer's refusal** to respond, or a limited response, as a **scope limitation** that may lead to a qualified opinion or disclaimer. A lawyer's limiting a response to matters to which the lawyer has given substantive attention, or to amounts above a materiality level agreed with the auditor, is not a scope limitation.

The legal letter's response date should be as close as possible to the **report date**.

Audit documentation (AU-C 230)

Documentation must be sufficient to enable an **experienced auditor, having no previous connection with the audit**, to understand the nature, timing and extent of procedures, the results and evidence obtained, and significant findings and conclusions. It records who performed and reviewed the work and when, identifying characteristics of items tested, significant findings and how inconsistent evidence was resolved. Timelines and retention are in Chapter 3 (AICPA 60 days / 5 years; PCAOB 14 days / 7 years).

Worked examples

Example: Choosing the direction of a test. The risk is that sales are overstated through fictitious invoices.

- Assertion at risk: **occurrence** of sales.
- Direction: start from recorded sales in the sales journal and **vouch** back to shipping documents and customer orders.
- Tracing shipping documents into the journal would test **completeness**, which is not the risk.

Example: Negative confirmations? Elena audits a utility with 40,000 residential accounts averaging $120. Controls are effective, RMM is low, few disputes are expected and customers read their bills. She also has 6 commercial accounts of $300,000 each.

- Residential accounts: all four conditions met → **negative** confirmations acceptable.
- Commercial accounts: large balances → use **positive** confirmations.

Example: Judgmental misstatement in an estimate. Management's allowance for doubtful accounts is $410,000. The auditor's supported range is $450,000 to $520,000.

- Management's estimate is below the range.
- Misstatement = $450,000 − $410,000 = **$40,000** (allowance understated; receivables and income overstated).
- The auditor accumulates $40,000, not the difference to the midpoint.

Common traps

- Confusing vouching (existence) with tracing (completeness).
- Treating management inquiry as sufficient evidence.
- Letting the client mail or collect confirmations.
- Using negative confirmations for large balances or high-risk populations.

Key takeaways

- Evidence must be sufficient (quantity) and appropriate (relevant and reliable). External, direct, documentary and original evidence is most reliable.
- Assertions: occurrence/existence, completeness, accuracy/valuation, cutoff, classification, rights and obligations, presentation.
- Vouch back for existence; trace forward for completeness.
- Higher risk → better nature, later timing, greater extent. Substantive procedures for every material class, balance and disclosure; tests of details for significant risks addressed only substantively.
- Confirmations: auditor controls the process; nonresponses → alternative procedures; negative confirmations only under four conditions.
- Estimates: test management's process, develop a point estimate or range, or use subsequent events; misstatement to the nearest end of the range.
- Documentation must let an experienced auditor with no connection to the audit understand the work.

9. Audit Sampling

Audit sampling means applying an audit procedure to **less than 100%** of the items in a population so that every sampling unit has a chance of selection, and using the results to conclude about the whole population (AU-C 530; AS 2315 for issuers). AUD tests the vocabulary of sampling risk, the factors that change sample size, and three computations: **attribute sampling** for tests of controls, **monetary unit sampling (MUS)** and **classical variables sampling** for substantive tests.

Sampling and nonsampling risk

Risk	Meaning	Controlled by
Sampling risk	The sample conclusion differs from the conclusion on the whole population	**Sample size** and selection method
Nonsampling risk	Any other reason for a wrong conclusion — wrong procedure, misread evidence, failure to recognize a deviation	Quality management: planning, supervision, training

Sampling risk has two directions in each kind of test:

Test	Risk that hurts effectiveness (wrong opinion)	Risk that hurts efficiency (extra work)
Tests of controls	**Risk of overreliance** (assessing control risk too low)	Risk of underreliance (assessing control risk too high)
Substantive tests	**Risk of incorrect acceptance** (accepting a materially misstated balance)	Risk of incorrect rejection

> **Memory trick:** "Over and Accept are the dangerous pair." Overreliance and incorrect acceptance lead to an audit failure; the other two only cost time.

What is not sampling

Testing **all** items, testing all items above a threshold (**100% of a stratum**), or selecting specific items that are not intended to represent the population (for example, only large or unusual items) is **not** audit sampling.

Statistical versus nonstatistical sampling

Both are acceptable under GAAS. **Statistical** sampling uses random selection and probability theory to **measure** sampling risk; **nonstatistical** sampling relies on judgment but must still be designed so the sample is expected to be representative. Selection

methods include random, systematic (every *n*th item from a random start), monetary unit (probability proportional to size), haphazard (no conscious bias — not for statistical sampling) and block selection (generally inappropriate).

Factors that change sample size

Factor (others constant)	Tests of controls	Substantive tests
Tolerable rate / tolerable misstatement **increases**	Decrease	Decrease
Expected deviation rate / expected misstatement **increases**	Increase	Increase
Acceptable risk of overreliance / incorrect acceptance **increases**	Decrease	Decrease
Planned reliance on control / assessed RMM **increases**	Increase	Increase
Population size increases (large populations)	**Little or no effect**	Increase (larger dollar populations need more items)
Stratification reduces variability (classical)	—	Decrease

> **Exam tip:** Sample size moves **inversely** with what you can tolerate and the risk you can accept, and **directly** with what you expect to find and how much assurance you need.

Attribute sampling (tests of controls)

Attribute sampling estimates the **rate of deviation** from a control. The auditor defines the control, the deviation and the population, sets the **tolerable deviation rate** and the acceptable **risk of overreliance**, estimates the **expected deviation rate**, and determines sample size. This guide (like the practice bank) uses **Poisson reliability factors**, which give the same results as the tables in common use for zero or few expected deviations.

Reliability factors used in this guide

Number of deviations (k)	95% confidence (5% risk)	90% confidence (10% risk)
0	3.00	2.30
1	4.74	3.89
2	6.30	5.32
3	7.75	6.68
4	9.15	7.99

(Some published tables round the 90% zero-deviation factor to 2.31; the bank states each factor in the question.)

Formulas

- **Sample size** (zero expected deviations) = reliability factor for 0 deviations ÷ tolerable rate.
- **Sample deviation rate** = deviations found ÷ sample size.
- **Upper deviation limit (UDL)** = reliability factor for the deviations found ÷ sample size.
- **Allowance for sampling risk** = UDL − sample deviation rate.
- **Decision**: rely on the control as planned only if **UDL ≤ tolerable rate**.

Example: Attribute sample size. Tolerable rate 5%, risk of overreliance 5%, no deviations expected.

- Sample size = 3.00 ÷ 0.05 = **60**.
- With a 4% tolerable rate: 3.00 ÷ 0.04 = **75**. With 6%: 3.00 ÷ 0.06 = **50**.
- With 10% risk (factor 2.30) and 5% tolerable rate: 2.30 ÷ 0.05 = 46.0 → **46**.

Example: Evaluating an attribute sample. Rahul tested 80 disbursements for approval. Tolerable rate 6%, risk of overreliance 5%.

- **One deviation:** sample rate = 1 ÷ 80 = 1.25%. UDL = 4.74 ÷ 80 = **5.9%** (5.925%). Allowance = 5.9% − 1.25% = 4.7%. UDL 5.9% ≤ 6% → **rely** on the control as planned.
- **Two deviations:** sample rate = 2.5%. UDL = 6.30 ÷ 80 = **7.9%** (7.875%). UDL > 6% → **do not rely** as planned; assess control risk higher and expand substantive procedures.

Watch out: Compare the **upper deviation limit**, not the sample deviation rate, with the tolerable rate. A 2.5% sample rate looks fine against 6%, but the UDL of 7.9% does not.

Also consider the **qualitative** nature of deviations: a deviation caused by **fraud** or intentional override is more serious than its rate suggests.

Monetary unit sampling (MUS)

MUS (probability-proportional-to-size sampling) treats each **dollar** as a sampling unit, so larger items are more likely to be selected. It is best for testing **overstatement** (existence) with few expected misstatements. It is weak at finding understatements and zero or negative balances, which have no or little chance of selection.

Planning

- **Sampling interval** = (tolerable misstatement − expected misstatement × expansion factor) ÷ reliability factor for 0 misstatements.
- **Sample size** = population book value ÷ sampling interval.
- Expansion factors in this guide: **1.6** at 5% risk of incorrect acceptance, **1.5** at 10%.
- Every item with a book value **≥ the interval** is certain to be selected (the "top stratum").

Example: MUS interval and sample size. Receivables book value $6,000,000; tolerable misstatement $150,000; risk of incorrect acceptance 5% (factor 3.00); expected misstatement $20,000; expansion factor 1.6.

- Interval = ($150,000 − $20,000 × 1.6) ÷ 3.00 = ($150,000 − $32,000) ÷ 3.00 = **$39,333**.
- Sample size = $6,000,000 ÷ $39,333.33 = 152.54 → **153** items.
- With no expected misstatement: interval = $150,000 ÷ 3.00 = $50,000; sample size = $6,000,000 ÷ $50,000 = **120**. Expected misstatement shrinks the interval and enlarges the sample.

Projecting misstatements

Item's book value	Projected misstatement
Less than the interval	**Tainting %** × interval, where tainting = (book value − audited value) ÷ book value
At least the interval	The **actual** misstatement (book value − audited value) — no projection

Upper misstatement limit (UML)

UML = **basic precision** + **projected misstatements** + **incremental allowance for sampling risk**

- Basic precision = reliability factor for 0 misstatements × interval.
- Projected misstatements: rank the projections from items smaller than the interval by **tainting**, largest first.
- Incremental allowance = for each ranked projection, (increase in reliability factor − 1) × projection.
- Actual misstatements in items **at least as large as the interval** are added in full, with **no** incremental allowance.
- If UML ≤ tolerable misstatement, the auditor can conclude the population is not misstated by more than tolerable misstatement at the chosen risk.

Example: Computing UML. Interval $40,000, 95% confidence. The sample found three overstatements:

Item	Book value	Audited value	Treatment	Projection
A	$5,000	$3,000	Tainting 40% × $40,000	$16,000
B	$20,000	$18,000	Tainting 10% × $40,000	$4,000
C	$52,000	$47,000	≥ interval: actual	$5,000

- Basic precision = 3.00 × $40,000 = **$120,000**.
- Incremental allowance, ranked by tainting: A: (4.74 − 3.00 − 1) × $16,000 = 0.74 × $16,000 = $11,840; B: (6.30 − 4.74 − 1) × $4,000 = 0.56 × $4,000 = $2,240. Total **$14,080**.
- UML = $120,000 + ($16,000 + $4,000) + $14,080 + $5,000 = **$159,080**.
- Against tolerable misstatement of $150,000, UML **exceeds** tolerable misstatement. The auditor cannot accept the balance as is: ask management to investigate and correct, expand testing, or use other procedures — and consider the effect on the opinion if not resolved.

Classical variables sampling

Classical variables sampling uses the normal distribution and works well when many misstatements are expected, when understatements matter, and with zero and negative balances. It needs an estimate of the population **standard deviation**; stratification reduces variability and sample size.

Method	Estimated audited population value
Mean-per-unit (MPU)	Average audited value per sample item × number of items in the population
Difference estimation	Population book value + (average difference per item × number of items)
Ratio estimation	Population book value × (sample audited value ÷ sample book value)

Difference and ratio estimation need book values for each item and **many differences** in the sample; ratio is preferred when differences are proportional to book values, difference when they are not.

Example: Classical estimates. Population: 4,000 accounts, book value $1,950,000. Sample of 200 items: book value $96,000, audited value $94,400.

- **MPU:** average audited value = $94,400 ÷ 200 = $472; estimate = $472 × 4,000 = **$1,888,000**.
- **Difference:** average difference = ($94,400 − $96,000) ÷ 200 = −$8; estimate = $1,950,000 + (−$8 × 4,000) = **$1,918,000** (projected misstatement $32,000 overstatement).
- **Ratio:** ratio = $94,400 ÷ $96,000 = 0.98333; estimate = $1,950,000 × 0.98333 = **$1,917,500** (projected misstatement $32,500).

MPU differs from the other two because it ignores book values; the sample's average book value ($480) is below the population average ($487.50), and MPU absorbs that difference as if it were misstatement.

Common traps

- Comparing the sample deviation rate instead of the UDL with the tolerable rate.
- Using tainting × interval for an item larger than the interval.
- Thinking population size matters much for large attribute samples.
- Forgetting that expected misstatement **reduces** the MUS interval and **increases** sample size.
- Treating haphazard selection as acceptable for statistical sampling.

Key takeaways

- Sampling risk is controlled by sample size; nonsampling risk by quality management.
- Overreliance and incorrect acceptance hurt effectiveness; underreliance and incorrect rejection hurt efficiency.

- Attribute: n = factor ÷ tolerable rate; UDL = factor for deviations found ÷ n; rely only if UDL ≤ tolerable rate.
- MUS: interval = (TM − EM × EF) ÷ RF; n = BV ÷ interval; small items projected with tainting × interval, large items at actual; UML = basic precision + projections + incremental allowance.
- Classical: MPU, difference and ratio estimation; good for understatements, zero balances and many misstatements.

10. Cash, Receivables & Revenue

Revenue is where most financial reporting frauds happen, receivables are the balance sheet side of revenue, and cash is the most liquid asset to steal. AUD tests specific procedures for each: bank reconciliations and kiting for cash, confirmations and allowance testing for receivables, and cutoff and unusual arrangements for revenue.

Cash

Key risks and procedures

Assertion	Risk	Procedures
Existence	Fictitious balances, kiting	**Standard bank confirmation**, review of bank reconciliation, **cutoff bank statement**
Completeness	Unrecorded accounts or receipts	Bank confirmation (asks for all deposit and loan balances), review of minutes, interbank transfer schedule
Rights and obligations	Restricted cash, compensating balances	Confirm with bank; read loan agreements
Presentation	Restricted or overdrawn accounts misclassified	Read agreements; review disclosures

The **standard form to confirm account balance information with financial institutions** (developed by the AICPA and the banking industry) confirms deposit balances and direct loan balances. The bank is **not** asked to search its records beyond what the form requests, so it is not a complete search for all liabilities.

A **cutoff bank statement** is a statement for a short period after year-end (often 7–10 days or more) sent **directly to the auditor**. The auditor uses it to verify that deposits in transit cleared promptly and that outstanding checks cleared for the right amounts.

Bank reconciliation

The auditor tests the client's reconciliation by agreeing the bank balance to the confirmation, agreeing the book balance to the ledger, vouching reconciling items to the cutoff statement, and investigating unusual items.

Bank side adjustments	Book side adjustments
+ Deposits in transit	+ Interest earned, collections by the bank (notes collected)
− Outstanding checks	− Bank service charges, **NSF** (bounced) customer checks
± Bank errors	± Book errors (transposed amounts)

Both sides must equal the **adjusted (correct) cash balance**. Only book-side items require journal entries.

Example: Bank reconciliation. Delmar Freight, December 31. Bank statement balance $84,600; book balance $80,390. Deposits in transit $12,300; outstanding checks $16,850; bank service charge $90; NSF customer check $1,200; note collected by bank $1,000 plus $40 interest; a check for supplies of $650 was recorded in the books as $560.

- Bank side: $84,600 + $12,300 − $16,850 = **$80,050**.
- Book side: $80,390 − $90 − $1,200 + $1,000 + $40 − ($650 − $560) = $80,390 − $90 − $1,200 + $1,040 − $90 = **$80,050**.
- Both sides agree at the adjusted balance of **$80,050**. The client records entries only for the book-side items (fee, NSF check, note and interest, and the $90 error). Had the sides not agreed, the auditor would investigate — an unreconciled difference can signal an unrecorded item or theft and must never be "plugged."

Kiting and the interbank transfer schedule

Kiting hides a cash shortage by writing a check on one bank account and depositing it in another near year-end, so the cash is counted in both accounts. The **receipt** is recorded in the current year, but the **disbursement** is recorded in the **next** year (or not at all). The auditor prepares an **interbank transfer schedule** listing transfers around year-end with dates recorded in the books and dates cleared by each bank, and looks for disbursements recorded after year-end for receipts recorded before.

Proof of cash

A **four-column proof of cash** reconciles beginning balance, receipts, disbursements and ending balance between bank and books for a period. It detects unrecorded receipts or disbursements that offset within the period (for example, a theft concealed by an equal unrecorded deposit).

Receivables

Confirmation is presumed

AU-C 330 presumes the auditor will **confirm accounts receivable** unless:

1. the receivables are **immaterial**,
2. confirmations would be **ineffective** (for example, customers are known not to respond), or
3. the assessed RMM is **low** and other substantive procedures address the risk.

If the auditor does not confirm, the reason must be **documented**. Confirmations best test **existence**; they provide limited evidence about **valuation** (a customer may confirm a balance it cannot pay) and almost none about **completeness**.

Exceptions and nonresponses

Situation	Response
Customer says "paid on December 30"	Timing difference — trace to cash receipts after year-end; likely not a misstatement
Customer says "goods never received"	Possible cutoff error or fictitious sale — examine shipping documents
Customer disputes price	Possible misstatement — examine contract and invoice
No reply to a positive request	**Alternative procedures**: examine **subsequent cash receipts** (best), shipping documents, sales invoices and customer orders

Valuation: allowance for doubtful accounts

The auditor tests the **aging schedule** (footing, cross-footing, and testing the aging of selected invoices), reviews **subsequent collections**, discusses past-due accounts with the credit manager, reviews credit files, and evaluates management's method and assumptions (historical loss rates adjusted for current conditions — under current GAAP, expected credit losses).

Example: Testing the allowance with an aging. Management's allowance is $54,000. The auditor applies supported loss rates to the aged balances:

Age	Balance	Loss rate	Expected loss
Current	$820,000	1%	$8,200
31–60 days	$240,000	5%	$12,000
61–90 days	$95,000	20%	$19,000
Over 90 days	$60,000	50%	$30,000
Total	$1,215,000		$69,200

- Auditor's estimate = $8,200 + $12,000 + $19,000 + $30,000 = **$69,200**.
- Management's allowance is understated by $69,200 − $54,000 = **$15,200** (bad debt expense and income overstated). If the auditor had developed a range, the misstatement would be measured to its nearest end.

Lapping

Lapping is covering the theft of one customer's payment with a later customer's payment. Detect it by comparing the **details of remittance advices and deposit slips** with postings to customer accounts (names, amounts and dates), confirming balances, and insisting on segregation of duties (Chapter 6).

Revenue

Revenue carries a **presumed fraud risk** (Chapter 5). Under ASC 606, revenue is recognized when (or as) the entity transfers control of goods or services. Audit focus areas:

Area	What to look for	Procedures
Cutoff	Sales recorded before shipment/transfer of control	Examine shipping documents for the last and first several days around year-end; compare to invoice dates
Shipping terms	FOB shipping point: sale when goods leave the seller; FOB destination: sale when goods arrive	Read terms on shipping documents and contracts
Side agreements	Undisclosed rights of return, extended payment terms, cancellation rights	Confirm **terms** (not just balances) with customers; inquire of sales staff
Bill-and-hold	Revenue for goods the seller still holds	Verify the customer obtained control: substantive reason for the arrangement, goods identified as the customer's, ready for transfer and not usable or redirectable by the seller
Channel stuffing	Pushing excess inventory to distributors at year-end	Analyze year-end sales spikes and subsequent returns and credit memos
Contract estimates	Variable consideration, over-time recognition, multiple performance obligations	Test estimates and the allocation of transaction price

Substantive analytical procedures on revenue (units × price, revenue by month, gross margin by product) are useful but, because of the fraud presumption, are usually supported with tests of details.

Example: Cutoff test. Year-end is December 31. Three invoices dated December 30 for $18,000, $9,500 and $22,000 are recorded as December sales. Shipping documents show: the first shipped December 29 FOB shipping point; the second shipped January 3 FOB shipping point; the third shipped December 30 FOB destination and arrived January 4.

- Invoice 1: shipped before year-end, FOB shipping point → December sale, **correct**.
- Invoice 2: shipped in January → **not** a December sale. Overstatement $9,500.
- Invoice 3: FOB destination, arrived January 4 → control transfers on delivery, **not** a December sale. Overstatement $22,000.
- Sales and receivables are overstated by $9,500 + $22,000 = **$31,500** (with related cost of sales and inventory effects).

Common traps

- Adjusting the bank side for book items such as NSF checks or bank charges.
- Treating every confirmation exception as a misstatement.
- Ignoring FOB terms in cutoff questions.
- Using confirmations as evidence of collectibility.
- Relying on the bank confirmation as a complete search for unrecorded loans.

Key takeaways

- Cash: bank confirmation, test the reconciliation (bank side: deposits in transit, outstanding checks; book side: fees, NSF, collections, errors), cutoff statement, interbank transfer schedule for kiting, proof of cash.
- Receivables: confirmation presumed unless immaterial, ineffective, or low RMM addressed by other procedures; document if not confirmed. Nonresponses → subsequent cash receipts.
- Allowance: aging, subsequent collections, evaluate method and assumptions.
- Lapping is found by comparing remittance details with postings.
- Revenue: presumed fraud risk; cutoff with FOB terms; side agreements; bill-and-hold criteria; channel stuffing.

11. Inventory, PP&E, Liabilities & Equity

This chapter covers the remaining balance sheet areas. Each one has a signature risk: **existence and ownership** for inventory, **classification and valuation** for property, plant and equipment, **completeness** for liabilities, and **authorization** for equity. Learn the signature risk and the matching procedure, and most questions answer themselves.

Inventory

Observing the physical count

When inventory is material, the auditor must **attend the physical count** (unless impracticable) to evaluate management's instructions, observe the count procedures, inspect the inventory and perform **test counts**.

Test count direction	Assertion
From **count tags / listing to the floor** (pick a tag, find the goods)	**Existence**
From the **floor to the tags / listing** (pick goods, find the tag)	**Completeness**

The auditor records test counts and later traces them to the final inventory compilation, accounts for the **sequence of count tags** (used, unused and voided), notes obsolete or damaged goods, and obtains **cutoff information** (last receiving report and last shipping document numbers).

If the count is at a date **other than year-end**, the auditor needs effective controls and performs **rollforward** procedures between the count date and year-end. If the auditor cannot attend, the auditor performs alternative procedures (counting at a later date and rolling **back** to year-end); if that is impossible, there is a scope limitation.

Inventory held by **third parties** (public warehouses): confirm with the custodian and, if material, perform additional procedures.

Ownership — who owns the goods?

Situation	Owner at year-end
Goods in transit, **FOB shipping point**	**Buyer** (from shipment)
Goods in transit, **FOB destination**	**Seller** (until delivery)
Goods out on **consignment** (at the consignee's store)	**Consignor** — include in consignor's inventory
Goods held on consignment for others (**consigned-in**)	**Not** the holder's — exclude even though they are in the warehouse
Bill-and-hold goods meeting the criteria	Buyer

> **Watch out:** Ownership, not location, decides. Consigned-in goods sitting in the client's warehouse are **not** the client's inventory.

Valuation

- **Price tests**: vouch unit costs to vendor invoices (purchased goods) or cost records (manufactured goods: materials, labor, overhead allocation).
- **Lower of cost and net realizable value** (FIFO, average cost) or **lower of cost or market** (LIFO, retail): compare cost with **subsequent selling prices** less costs to complete and sell.
- **Obsolescence**: slow-moving reports, turnover analysis by product, observation of damaged goods at the count, and inquiry of production and sales staff.

Property, plant and equipment

The beginning balance is usually supported by the prior audit, so the auditor focuses on **current-year changes**.

Area	Procedures
Additions	Vouch to invoices, contracts and board approvals; **physically inspect** major additions; check proper capitalization (cost includes freight, installation, testing)
Repairs and maintenance	Analyze the expense account for items that should have been **capitalized** (understated assets)
Disposals	Look for unrecorded retirements: review miscellaneous income for scrap sales, insurance recoveries, property tax and insurance records, and new additions that replace old assets; recompute gain or loss
Depreciation	Recalculate; evaluate useful lives and methods; overall analytical test (depreciation ÷ average gross cost)
Impairment	Consider indicators (idle assets, declining cash flows) and test management's analysis
Rights	Inspect deeds, titles, property tax bills; read leases and loan agreements for liens

Example: Recalculating depreciation. A delivery truck costing $96,000 with a $6,000 salvage value and a 5-year life was placed in service on April 1 of the current calendar year.

- Straight-line annual depreciation = ($96,000 − $6,000) ÷ 5 = $18,000.
- Current year (9 months, April–December) = $18,000 × 9/12 = **$13,500**.
- If the client used double-declining balance, the rate is 2 ÷ 5 = 40% applied to cost **without** subtracting salvage: first full year = $96,000 × 40% = $38,400; second full year = ($96,000 − $38,400) × 40% = $23,040. Salvage only limits the total, so the asset is not depreciated below $6,000.
- If the client recorded a full year of straight-line ($18,000), depreciation is overstated by $18,000 − $13,500 = $4,500.

Liabilities

Accounts payable — the completeness risk

Management is more likely to **understate** liabilities than to overstate them. So the main audit focus is **completeness**, and the main procedure is the **search for unrecorded liabilities**:

- Examine **cash disbursements after year-end** (up to the fieldwork date) and trace to the year-end payables listing when the obligation arose before year-end.

- Examine **unpaid invoices** and unmatched receiving reports received near and after year-end.
- Compare **receiving reports** dated before year-end with recorded payables (cutoff).
- Review contracts, minutes and the legal letter for commitments and contingencies.

Confirming payables is optional and less common than confirming receivables, because the vendor statement is strong external evidence and the risk is unrecorded amounts. When confirmations are used, send them to **regular vendors** — including those with **small or zero balances** — rather than only to large recorded balances, since the aim is finding understatements.

> **Exam tip:** For receivables, the auditor selects from the recorded balances (testing existence). For payables, the auditor selects from **vendors the client does business with** and from **subsequent payments** (testing completeness).

Debt and other liabilities

- **Confirm** notes and bonds with lenders and trustees (balance, interest rate, collateral, payment terms).
- **Read debt agreements** and **recompute covenant ratios** using audited figures. A covenant violation that is not waived may make long-term debt **current** and may raise going concern issues.
- **Recalculate interest** expense and accrued interest; an analytical test (average debt × rate) is effective.
- **Contingencies**: legal letters, minutes, and management representations (Chapters 8 and 14).

Equity

Equity transactions are few and large, so auditors generally test them in full (100%).

Area	Procedures
Authorization	Read the **articles of incorporation, bylaws and board minutes** for shares authorized, issuances, dividends and treasury stock purchases
Shares outstanding	**Confirm** with the independent **registrar and transfer agent**, or inspect the stock certificate book if the entity has no transfer agent
Dividends	Recompute declared dividends (shares outstanding at record date × rate); trace payments
Treasury stock	Vouch purchases; inspect certificates or confirm
Retained earnings	Analyze all changes: net income, dividends, prior-period adjustments

Example: Inventory ownership at year-end. On December 31 the client's warehouse holds $500,000 of goods, including $40,000 held on consignment for a supplier. Separately, $25,000 of goods purchased FOB shipping point were shipped December 30 and arrive January 3, and $18,000 of goods the client sold FOB destination are in transit to a customer.

- Start with goods in the warehouse: $500,000.
- Exclude consigned-in goods: −$40,000.
- Add purchases in transit, FOB shipping point (client owns from shipment): +$25,000.
- Add goods sold FOB destination still in transit (client owns until delivery): +$18,000.
- Correct inventory = $500,000 − $40,000 + $25,000 + $18,000 = **$503,000**.

Common traps

- Including consigned-in goods because they are in the warehouse.
- Confirming only large payables when the risk is unrecorded liabilities.
- Forgetting partial-year depreciation, or subtracting salvage when computing the DDB rate base.

Key takeaways

- Inventory: observe the count; tags-to-floor for existence, floor-to-tags for completeness; ownership by FOB terms and consignment; price tests and lower of cost and NRV.
- PP&E: focus on additions, disposals, repairs that should be capitalized and depreciation recalculation.
- Liabilities: completeness via the search for unrecorded liabilities (subsequent disbursements, unpaid invoices, receiving reports); confirm with regular vendors, even zero balances; recompute covenants.
- Equity: read articles, bylaws and minutes; confirm with the transfer agent; test dividends and treasury stock.

12. Analytical Procedures & Data Analytics

Analytical procedures evaluate financial information by studying **plausible relationships** among financial and nonfinancial data (AU-C 520; AS 2305 for issuers). They are fast, cheap and often reveal where problems hide. Audit data analytics (ADAs) extend the idea to whole populations using software. AUD tests when analytics are required, the conditions for using them as substantive evidence, the ratios, and how to interpret unexpected results.

When analytical procedures are used

Stage	Required?	Purpose
Risk assessment (planning)	**Required**	Identify unusual relationships and areas of higher risk
Substantive procedures	Optional	Obtain evidence about an assertion, alone or with tests of details
Final review (near the end)	**Required**	Form an overall conclusion on whether the statements are consistent with the auditor's understanding

> **Memory trick: "Beginning and end — always; middle — maybe."**

Planning analytics often use aggregated data and give only a broad indication of risk. Final analytics are done by a senior team member and may identify a previously unrecognized RMM, leading to more procedures.

Substantive analytical procedures

A substantive analytical procedure follows four steps:

1. **Develop an expectation** — independent and precise enough to identify a material misstatement.
2. **Define a threshold** — the difference from the expectation that can be accepted without further investigation (based on materiality and the desired assurance).
3. **Compare** the recorded amount with the expectation.
4. **Investigate** differences above the threshold — inquire of management **and corroborate** the explanation with other evidence; perform other procedures if needed.

Factors in effectiveness

Factor	Better precision when...
Suitability for the assertion	The relationship is plausible and **predictable** (income statement accounts, stable environments)
Reliability of the data	Data come from independent external sources, or internal sources with effective controls, or data that were themselves audited
Precision of the expectation	Data are **disaggregated** (by month, product, location); more variables are used; the relationship is stable
Acceptable difference	A smaller threshold gives more assurance

Relationships in the **income statement** tend to be more predictable than balance sheet amounts, because they accumulate transactions over a period. Accounts affected by management discretion (for example, repairs, advertising) are less predictable.

Watch out: An expectation built from the **same unaudited data** being tested is not independent. Comparing this year's recorded revenue with this year's budget prepared from the same records gives weak evidence.

Example: Reasonableness test of rental revenue. An apartment owner has 240 units; average occupancy was 92%, verified to independent occupancy reports; the average monthly rent is $1,450, agreed to the rent roll. Recorded revenue is $3,960,000. The threshold is $120,000.

- Expectation = 240 × 92% × $1,450 × 12 = **$3,841,920**.
- Difference = $3,960,000 − $3,841,920 = **$118,080** (recorded above expected).
- $118,080 is below the $120,000 threshold, so no further investigation is required. Had it exceeded the threshold, the auditor would ask management why and **corroborate** the answer (for example, with late fees in the lease agreements).

Common ratios

Ratio	Formula	What a change can signal
Current ratio	Current assets ÷ current liabilities	Liquidity; a sudden improvement may hide unrecorded payables
Quick (acid-test) ratio	(Cash + receivables + marketable securities) ÷ current liabilities	Liquidity without inventory
Accounts receivable turnover	Net credit sales ÷ **average** receivables	Falling turnover → collection problems, fictitious sales, understated allowance
Days sales in receivables	365 ÷ AR turnover	Rising days → same as above
Inventory turnover	Cost of goods sold ÷ **average** inventory	Falling turnover → obsolescence or overstated inventory
Days in inventory	365 ÷ inventory turnover	
Gross margin %	(Sales − COGS) ÷ sales	Unexpected rise → overstated inventory, fictitious sales, unrecorded purchases
Debt to equity	Total liabilities ÷ total equity	Solvency, covenant risk
Times interest earned	Earnings before interest and taxes ÷ interest expense	Ability to service debt
Return on assets / equity	Net income ÷ average assets / equity	Profitability

Exam tip: A **higher gross margin** combined with **lower inventory turnover** is the classic pattern for **overstated ending inventory** (which understates COGS and inflates margin, while the larger inventory slows turnover).

Example: Computing ratios. Data: current assets $1,450,000; current liabilities $800,000; cash $150,000; receivables $420,000; marketable securities $60,000; credit sales $3,650,000; receivables beginning $380,000, ending $420,000; COGS $2,400,000; inventory beginning $500,000, ending $700,000.

- Current ratio = $1,450,000 ÷ $800,000 = **1.81**.
- Quick ratio = ($150,000 + $420,000 + $60,000) ÷ $800,000 = $630,000 ÷ $800,000 = **0.79**.
- AR turnover = $3,650,000 ÷ [($380,000 + $420,000) ÷ 2] = $3,650,000 ÷ $400,000 = **9.13 times**; days sales = 365 ÷ 9.125 = **40 days**.
- Inventory turnover = $2,400,000 ÷ [($500,000 + $700,000) ÷ 2] = $2,400,000 ÷ $600,000 = **4.0 times**; days in inventory = 365 ÷ 4 = **91.25 days**.
- If last year's inventory turnover was 5.5 times with a lower gross margin, the drop to 4.0 alongside a rising margin points the auditor to **inventory existence and valuation**.

Audit data analytics

Audit data analytics are techniques for discovering and analyzing patterns, identifying anomalies and extracting useful information in data underlying or related to the subject matter, through analysis, modeling and visualization. They can be used in risk assessment, tests of controls, substantive procedures and the final review.

Technique	Use
Filtering and sorting	Find entries over a threshold, posted on weekends or by unusual users
Matching / joining	Match vendor master file addresses with employee addresses (fictitious vendors); three-way match testing for every transaction
Gap and duplicate testing	Missing check numbers; duplicate invoice payments
Stratification and aging	Profile populations; age receivables
Visualization	Plot sales by day to spot year-end spikes
Regression	Build precise expectations from several variables
Benford's Law	Compare the frequency of leading digits with the expected distribution (about 30% of naturally occurring numbers start with 1); excess clusters (for example, just below an approval limit) suggest manipulation

When an ADA covers **100% of a population**, it is not sampling, but the auditor still needs to evaluate the **reliability** of the data (completeness and accuracy of the extract), investigate flagged items, and recognize that an ADA showing no exceptions provides evidence only about the attributes it tested. Items flagged by an ADA are not automatically misstatements; they require follow-up.

Common traps

- Accepting management's explanation of a difference without corroboration.
- Using year-end instead of average balances for turnover ratios.
- Assuming every difference from the expectation is a misstatement.
- Thinking substantive analytics are required — only planning and final analytics are.
- Believing an ADA over a whole population removes the need to test data reliability.

Key takeaways

- Required at planning (risk assessment) and near the end (final review); optional as substantive procedures.
- Substantive analytics: independent precise expectation, threshold, compare, investigate and corroborate.
- Precision improves with disaggregated, reliable data and predictable relationships (income statement accounts).
- Know the liquidity, activity, profitability and coverage ratios; higher margin plus lower inventory turnover suggests overstated inventory.
- ADAs (filtering, matching, gaps, duplicates, visualization, regression, Benford's Law) can test entire populations but require data reliability checks and follow-up of exceptions.

13. Using the Work of Others

Auditors rarely do everything themselves. They may use the client's **internal audit function**, **specialists** (appraisers, actuaries, IT experts), **service organization** reports, and **component auditors** in a group audit. In every case except "making reference" to a component auditor, the group or principal auditor keeps **sole responsibility** for the opinion, so the exam tests how the auditor evaluates the other party and how the work is reflected (or not) in the report.

Who is who

Party	Belongs to	Example
Internal audit function	The entity	Client staff reporting to the audit committee who test purchasing controls
Management's specialist	Engaged by the entity to help **prepare** the statements	Actuary who computes the pension obligation
Auditor's specialist	Engaged (or employed) by the **auditor** to obtain evidence	Appraiser hired by the firm to test real estate impairment
Service organization	Outside provider whose services are part of the user entity's information system	Payroll processor, cloud ERP host, bank trust department
Component auditor	Another auditor (other firm or other office) that audits part of a group	Foreign firm auditing a subsidiary

Internal audit function (AU-C 610)

The external auditor may use internal audit's work in two ways:

1. **Using the work** of the function (for example, its tests of controls) to modify the nature, timing or extent of the external auditor's procedures.
2. **Direct assistance** — internal auditors perform procedures under the **direction, supervision and review** of the external auditor.

Before using either, the auditor evaluates:

Factor	Questions
Objectivity	Organizational status (reports to the audit committee or board?), policies that protect objectivity, conflicting responsibilities
Competence	Education, experience, certification, training, resources
Systematic and disciplined approach (for using the function's work)	Documented procedures, quality control, planning and supervision

Limits:

- The external auditor makes **all significant judgments** and decides on the overall use.
- The more the work involves **significant judgment**, **high assessed RMM**, or the less the function's objectivity and competence, the **less** the auditor may use it.
- **Direct assistance** may not be used for procedures that involve significant judgments, relate to higher assessed risks, involve work with which the internal auditors have been involved and which has already or will be reported to management, or relate to decisions about the audit, including the use of the internal audit function.
- For direct assistance, the auditor obtains written agreements: from the entity that internal auditors may follow the auditor's instructions without interference, and from the internal auditors that they will keep matters confidential and tell the auditor of threats to objectivity.
- The external auditor must **reperform** some of the work used, more for higher-judgment areas.

> **Watch out:** Internal auditors can never make **significant judgments** for the external auditor, and the external auditor's report does **not** mention internal audit.

Specialists

Auditor's specialist (AU-C 620, SAS No. 144)

The auditor evaluates the specialist's **competence, capabilities and objectivity** (including interests and relationships with the client), obtains an understanding of the specialist's field, agrees in writing (where appropriate) on the nature, scope and objectives of the work, roles, and confidentiality, and evaluates the **adequacy of the specialist's work**: the relevance and reasonableness of findings, significant assumptions and methods, and source data.

Management's specialist (AU-C 500)

When information prepared by management's specialist is used as audit evidence, the auditor evaluates the specialist's competence, capabilities and objectivity, obtains an understanding of the work, and evaluates its appropriateness as evidence — including testing the data and assumptions used.

Report reference

Report type	May the auditor name the specialist?
Unmodified opinion	**No** — referring could suggest divided responsibility
Modified opinion, if reference helps explain the modification	Yes, and the report states that the reference does not reduce the auditor's responsibility

Service organizations (AU-C 402)

A **user auditor** audits a **user entity** that relies on a **service organization**. The user auditor must understand how the user entity uses the service organization's services. It can obtain evidence by visiting the service organization, using a **type 1 or type 2 report** prepared by a **service auditor**, or testing controls at the user entity over the service.

Report	Covers	Assurance level and use
SOC 1 Type 1	Fairness of management's description and **suitability of design** of controls **as of a date**	Helps the user auditor understand controls; **cannot** be used to reduce control risk
SOC 1 Type 2	Description, design **and operating effectiveness** over a **period** (usually 6–12 months)	Can support a lower control risk assessment if it covers the relevant controls and period
SOC 2	Controls relevant to the trust services criteria — **security, availability, processing integrity, confidentiality, privacy**	Restricted to knowledgeable users (management, customers, regulators)
SOC 3	Same criteria as SOC 2 in a short report	**General use**
SOC for Cybersecurity	An entity's cybersecurity risk management program	General use

SOC 1 reports are examinations under **AT-C 320**.

Key points when using a SOC 1 type 2 report:

- Check that the report covers the **relevant controls** and **period**. If the report ends before the user's year-end, obtain evidence for the **gap period** (inquire about changes; obtain a **bridge letter** from the service organization).

- Evaluate the **complementary user entity controls (CUECs)** the service organization assumes the user has (for example, reviewing payroll registers), and test them if relying on them.
- Consider **subservice organizations** — whether they are carved out or included.
- Evaluate the service auditor's professional competence and independence.
- Do **not** refer to the service auditor's report in the user auditor's report (unless needed to explain a modified opinion).

> **Memory trick: "Type 1 = design at a point; Type 2 = design plus 'two'-ing it over time."** Only Type 2 tests operation.

Group audits and component auditors (AU-C 600)

In a group audit, the **group engagement partner** and team are responsible for the group audit opinion. They decide whether to **make reference** to a component auditor's audit in their report or to **assume responsibility** for it.

Approach	Requirements	Effect on the report
Assume responsibility (no reference)	The group team is sufficiently involved in the component auditor's work: understands it, evaluates competence and independence, communicates requirements, reviews documentation as needed	The report does not mention the component auditor
Make reference	The component auditor's work was performed under **relevant standards** (GAAS, or PCAOB/ISA with suitable reconciliation), the component's statements are prepared under the same framework, and the component auditor issued an auditor's report that is **not restricted** in use	The report states that another auditor audited part of the group, and shows the **portion** audited (for example, percentage of total assets and revenues). **The component auditor is not named** unless it agrees and its report is presented

Reference to another auditor is **not a qualification** — the opinion is still unmodified unless something else is wrong.

The group team must always understand the component auditor's **professional competence** and **independence**. If the component auditor is not independent, its work cannot be used and the group team must obtain the evidence itself.

Exam tip: SAS No. 149, *Special Considerations — Audits of Group Financial Statements*, applies for audits of periods ending on or after **December 15, 2026**. It strengthens the group engagement team's responsibilities, takes a risk-based approach to determining the components and the work to perform, and keeps the option to make reference to a component auditor. The ideas above — evaluate competence and independence, sufficient involvement if assuming responsibility, reference is not a qualification — hold under both standards.

Worked examples

Example: Gap period in a SOC 1 report. Sofia audits a calendar-year user entity. The payroll processor's SOC 1 type 2 report covers January 1–September 30.

- The report covers 9 of 12 months, so evidence is missing for **October–December**.
- Sofia inquires of user management about changes at the processor, obtains a **bridge letter** from the service organization, and considers testing user controls (such as review of payroll registers) for the remaining period.
- She does not mention the service auditor in her report.

Example: Using internal audit. Internal audit at Cobalt Ridge Mining reports to the CFO, whose bonus depends on reported earnings. It offers to test the impairment model for the mine assets — a significant risk.

- Objectivity is weak (reports to an executive with an incentive), and the area involves significant judgment and high RMM.
- The external auditor should **not** use internal audit's work on impairment and should not use direct assistance there. The auditor might still use its work on routine, low-risk controls after evaluating competence, with some reperformance.

Example: Making reference. The group auditor of Eastgate Textiles makes reference to the audit of a subsidiary by another firm. The subsidiary represents 18% of consolidated total assets and 22% of revenues.

- The report describes, in the opinion and basis sections, that other auditors audited the subsidiary, stating the 18% and 22% portions, and that the group auditor's opinion, insofar as it relates to those amounts, is based on the other auditors' report.
- The opinion remains **unmodified**.

Common traps

- Using a Type 1 report to reduce control risk.
- Letting internal auditors make significant judgments or work on high-risk areas through direct assistance.
- Naming a specialist in an unmodified report.
- Believing reference to a component auditor is a qualified opinion.
- Ignoring complementary user entity controls and gap periods.

Key takeaways

- Internal audit: evaluate objectivity, competence and a systematic approach; external auditor makes all significant judgments; limits on direct assistance.
- Specialists: evaluate competence, capabilities, objectivity and the work; no reference in an unmodified report.
- Service organizations: SOC 1 Type 1 = design at a date; Type 2 = operating effectiveness over a period; SOC 2 restricted, SOC 3 general use; consider CUECs and gap periods; no reference to the service auditor.
- Group audits: assume responsibility or make reference; reference requires relevant standards and an unrestricted report and is not a qualification. SAS No. 149 applies for periods ending on or after December 15, 2026.

14. Completing the Audit

The last weeks of an audit pull everything together: events after the balance sheet date, the going concern assessment, written representations, final analytical procedures, the evaluation of misstatements and the final communications. After the report is released, two more situations can arise: facts discovered later, and procedures found to have been omitted. This chapter covers them in the order they happen.

Subsequent events (AU-C 560; AS 2801)

Subsequent events occur between the **date of the financial statements** and the **date of the auditor's report**.

Type	Condition	Accounting	Examples
Recognized (Type I)	Gives evidence of conditions that **existed at the balance sheet date**	**Adjust** the statements	Customer bankruptcy from a deteriorating condition that existed at year-end; settlement of a lawsuit filed before year-end; sale of inventory below cost showing NRV at year-end
Nonrecognized (Type II)	Gives evidence of conditions that **arose after** the balance sheet date	**Disclose** if necessary to keep the statements from being misleading; do not adjust	Fire or flood after year-end; issuance of stock or bonds; business combination; lawsuit arising from an event after year-end; customer bankruptcy caused by an event after year-end

> **Memory trick: "Existed → adjust; arose → disclose."**

Procedures up to the report date

The auditor performs procedures covering the period from the statement date to (or as near as practicable to) the report date:

- Understand management's procedures for identifying subsequent events.
- Inquire of management and TCWG about subsequent events.
- Read **minutes** of owners', board and committee meetings held after year-end (and ask about meetings without minutes yet).
- Read the latest **interim financial statements**.
- Obtain the **legal letter** dated near the report date (Chapter 8).
- Obtain **written representations** dated as of the report date.

Dual dating

If a subsequent event occurring **after the report date but before the report release date** is disclosed in a note, the auditor may:

Option	Auditor's responsibility for events after the original report date
Dual date the report ("date, except for Note X, as to which the date is ...")	Limited to the **specific event** in Note X
Use the **later date** for the whole report	Extends to **all** events up to the new date — subsequent events procedures must be extended

Subsequently discovered facts

After the report date but before release: if management changes the statements, the auditor extends procedures and dates (or dual dates) the report accordingly.

After the report has been released, if the auditor becomes aware of a fact that **existed at the report date** and might have affected the report:

1. Discuss with management (and TCWG) and determine whether the statements need revision.
2. If revised, perform procedures on the revision, issue a new or revised report including an **emphasis-of-matter** or other-matter paragraph referring to the revision (nonissuer), and see that management informs users.
3. If management does **not** take the necessary steps, the auditor notifies management and TCWG, then — **after considering legal advice** — takes action to **prevent future reliance** on the report (for example, notifying regulators and known users).

Events that **arise after** the report is released (new conditions) do not require any action.

Omitted procedures (AU-C 585)

After the report release date, the auditor may discover that a necessary procedure was **omitted** (for example, during a peer review or internal inspection). The auditor assesses the importance of the omitted procedure to the ability to support the opinion. If the opinion could be affected and **people are relying (or likely to rely) on the report**, the auditor promptly performs the omitted procedure or alternative procedures. If those procedures reveal a problem, the subsequently discovered facts guidance applies.

Going concern (AU-C 570; AS 2415)

Under U.S. GAAP (ASC 205-40), **management** must evaluate whether there is substantial doubt about the entity's ability to continue as a going concern within **one year after the date the financial statements are issued (or available to be issued)**. The PCAOB

standard uses a reasonable period **not to exceed one year beyond the balance sheet date**.

Auditor's process

1. During risk assessment and throughout the audit, consider conditions and events that raise substantial doubt: recurring losses, negative cash flows, working capital deficiencies, **loan defaults** and covenant violations, denial of trade credit, loss of a key customer, legal proceedings, need to restructure debt.
2. If such conditions exist, evaluate **management's plans** to mitigate them (disposing of assets, borrowing or restructuring debt, reducing expenditures, increasing equity). Plans count only if they are **probable** of being effectively implemented and would mitigate the conditions.
3. Evaluate the adequacy of **disclosures**.
4. Obtain written representations about management's plans.

Reporting outcomes (nonissuer)

Conclusion	Report
No substantial doubt	No going concern language
Substantial doubt **alleviated** by management's plans, adequately disclosed	No going concern section required (an emphasis-of-matter paragraph is optional)
Substantial doubt **exists**, adequately disclosed	**Unmodified** opinion with a separate section headed "Substantial Doubt About the Entity's Ability to Continue as a Going Concern"
Substantial doubt exists, disclosure **inadequate**	**Qualified or adverse** opinion (misstatement)
Going concern basis **inappropriate** but used	**Adverse** opinion
Multiple significant uncertainties	The auditor may, in rare cases, **disclaim**

The going concern section does not use conditional language ("if the company continues to have losses..."). For issuers, the PCAOB requires an **explanatory paragraph** after the opinion section. A going concern paragraph is **not** a modification of the opinion.

Written representations (AU-C 580)

The auditor requests written representations from management with **appropriate responsibilities and knowledge** — usually the **CEO and CFO**.

Feature	Rule
Date	**As of the date of the auditor's report** (not the balance sheet date)
Periods covered	All statements and periods referred to in the report
Addressed to	The auditor
Required content	Management fulfilled its responsibility for preparing the statements; provided all information and access; all transactions recorded; **fraud** knowledge and allegations; **noncompliance** with laws; **uncorrected misstatements** are immaterial (with summary); litigation and claims; **related parties**; subsequent events; estimates' assumptions are reasonable; going concern plans if relevant

Representations **complement** other evidence; they do not replace it. If management refuses to provide representations on its **fundamental responsibilities** (preparation of statements, information and access), or the auditor concludes they are unreliable, the auditor must **disclaim** an opinion or **withdraw**. Refusal of other representations may lead to a qualified opinion or disclaimer, after the auditor reconsiders management's integrity.

Other completion steps

- **Final analytical procedures** (required — Chapter 12).
- **Evaluate misstatements** and their effect (Chapter 7); reassess materiality on actual results.
- **Review audit documentation**, including the engagement partner's review of significant matters and the **engagement quality review** where applicable (Chapter 3).
- **Read other information** in the annual report for material inconsistencies (Chapter 15).
- **Communicate** with TCWG (significant findings, uncorrected misstatements) and, in writing, significant deficiencies and material weaknesses (Chapter 6).
- **Date the report** no earlier than the date sufficient appropriate evidence has been obtained, including evidence that the statements (with notes) have been prepared and management has asserted responsibility for them.

Worked examples

Example: Classifying subsequent events. Year-end December 31; report date March 5.

1. January 20: a major customer files for bankruptcy because of losses that had been building for two years. **Recognized** — the condition (financial distress) existed at year-end → adjust the allowance.
2. February 8: a fire destroys a warehouse. **Nonrecognized** → disclose the loss if material.
3. February 15: a lawsuit filed in November is settled for $600,000 more than accrued. **Recognized** → adjust the liability.
4. February 28: the company issues $10 million of bonds. **Nonrecognized** → disclose.

Example: Dual dating. The report date is March 5. On March 12, before the report is released, the company agrees to acquire a competitor, and management adds Note 18.

- Dual-dated report: "March 5, except for Note 18, as to which the date is March 12." The auditor's responsibility after March 5 is limited to the acquisition.
- Alternatively, the auditor dates the whole report March 12 and extends subsequent events procedures to that date.

Example: Going concern decision. A nonissuer has defaulted on its bank loan and had three years of losses. Management plans to sell a division; a signed purchase agreement with financing in place is expected to close in two months and would cover the default.

- Conditions raise substantial doubt.
- The plan is probable of implementation (signed agreement, financing) and would mitigate the conditions → substantial doubt **alleviated**.
- Management must disclose the conditions and its plans. The opinion is unmodified, with no required going concern section. If the sale were only at the discussion stage, substantial doubt would remain and a separate going concern section would be required.

Common traps

- Adjusting the statements for a post-year-end fire or stock issuance.
- Treating a going concern section as a modified opinion.
- Dating the representation letter at the balance sheet date.

- Thinking dual dating extends responsibility for all events to the later date.
- Taking action for events that arose after the report was released.

Key takeaways

- Subsequent events: existed at year-end → adjust; arose after → disclose. Procedures run to the report date.
- Dual dating limits responsibility after the original date to the specific event.
- Facts that existed at the report date and are discovered after release: revise and reissue, or act to prevent reliance after legal advice.
- Omitted procedures: perform them if the opinion could be affected and users rely on the report.
- Going concern: one year after issuance (GAAP); substantial doubt with adequate disclosure → unmodified with a separate section; inadequate disclosure → qualified or adverse.
- Representations: dated as of the report date, signed by CEO and CFO; refusal of fundamental representations → disclaimer or withdrawal.

15. Audit Reports & Opinions

The report is the only part of the audit most users ever see. AUD tests its structure (which sections, in what order, saying what), the choice among four opinions, the paragraphs that add information without changing the opinion, and special reports. This chapter describes each report element in plain language; it does not reproduce the standards' illustrative wording.

The nonissuer auditor's report (AU-C 700, SAS No. 134)

Order	Element	What it does (plain words)
—	**Title**	Includes the word "independent" (for example, "Independent Auditor's Report")
—	**Addressee**	Usually those for whom the report is prepared — shareholders, the board, or as required by the engagement
1	**Opinion** section	Comes **first**. Names the entity and the statements audited (titles and dates or periods), refers to the notes, and states the opinion that the statements are presented fairly, in all material respects, under the named framework
2	**Basis for Opinion** section	Says the audit followed GAAS (U.S.), refers to the auditor's responsibilities section, states the auditor is **independent** and met other ethical responsibilities, and says whether the evidence is **sufficient and appropriate** to support the opinion
3	**Going concern** section (when applicable)	Headed "Substantial Doubt About the Entity's Ability to Continue as a Going Concern"; points to the disclosure; states the opinion is not modified
4	**Key audit matters** (only if engaged to report them)	Matters of most significance in the current audit, why each was a KAM, and how it was addressed
—	**Emphasis-of-matter / other-matter** paragraphs (when needed)	Placed where the auditor judges appropriate, with their own headings
5	**Responsibilities of Management for the Financial Statements**	Management prepares and fairly presents the statements, designs and maintains relevant internal control, and (where required by the framework) evaluates going concern
6	**Auditor's Responsibilities for the Audit of the Financial Statements**	Objective is **reasonable — not absolute — assurance**; misstatements from fraud are harder to detect than from error; the auditor uses judgment and skepticism, identifies and responds to risks, obtains an understanding of internal control **without** expressing an opinion on it, evaluates policies and estimates and overall presentation, concludes on going concern, and communicates with TCWG
7	**Other information** section (when the annual report contains it)	Identifies the other information, states management is responsible for it, says the opinion does not cover it, describes the auditor's duty to read it for material inconsistencies, and reports any uncorrected material misstatement of it

Order	Element	What it does (plain words)
—	**Other reporting responsibilities** (if any)	For example, supplementary information or GAGAS reports, in a separate section
—	**Signature, city and state, date**	Firm signature; location where the auditor practices; dated no earlier than when sufficient appropriate evidence was obtained

Memory trick: "**O-B-G-K, then M-A-O.**" Opinion, Basis, Going concern, KAMs — then Management, Auditor, Other information, sign and date.

The issuer auditor's report (PCAOB AS 3101)

Element	Difference from the nonissuer report
Title	Must be "Report of Independent Registered Public Accounting Firm"
Addressee	Shareholders **and** board of directors (or equivalents)
Opinion section	Comes first, as for nonissuers
Basis for Opinion	States management's responsibility and the auditor's responsibility here; the auditor is a **PCAOB-registered** firm required to be independent under **SEC and PCAOB** rules; audit conducted under **PCAOB standards**
Critical audit matters (CAMs)	**Required** (with exceptions such as emerging growth companies, brokers and dealers, investment companies other than BDCs, and benefit plans): matters **communicated or required to be communicated to the audit committee** that relate to **material accounts or disclosures** and involved **especially challenging, subjective or complex** auditor judgment. If none, the report says so
Auditor tenure	Statement of the year the auditor began serving consecutively
Going concern and other matters	**Explanatory paragraphs** (going concern, consistency, restatements)
ICFR	Integrated audit: opinions on statements and ICFR in combined or separate reports dated the same day

The opinion decision grid

First classify the problem, then decide whether it is **pervasive** (not confined to specific elements, or, if confined, a substantial part of the statements, or fundamental to users' understanding of disclosures).

Nature of the matter	Material, not pervasive	Material and pervasive
Statements are **materially misstated** (GAAP departure, inadequate disclosure)	**Qualified** ("except for")	**Adverse**
Unable to obtain **sufficient appropriate evidence** (scope limitation)	**Qualified** ("except for the possible effects")	**Disclaimer**

Memory trick: "**Misstatement → Adverse, Scope → Disclaim**" when pervasive; both give "except for" when not.

Report changes for modified opinions

Opinion	Opinion section heading	Basis section heading	Other changes
Qualified	"Qualified Opinion"	"Basis for Qualified Opinion" — describes the matter and quantifies its effects if practicable	Opinion says the statements are fairly presented **except for** the effects (or possible effects) of the matter
Adverse	"Adverse Opinion"	"Basis for Adverse Opinion"	Opinion says the statements are **not** fairly presented
Disclaimer	"Disclaimer of Opinion"	"Basis for Disclaimer of Opinion"	Says the auditor **does not express** an opinion; the basis section does **not** state that evidence is sufficient; the auditor's responsibilities section is shortened; no KAMs

A management-imposed scope limitation is more serious than one caused by circumstances. If management imposes a pervasive limitation after acceptance, the auditor **disclaims** or **withdraws** where possible.

Watch out: An **adverse** opinion never results from a scope limitation, and a **disclaimer** never results from a known misstatement. Also, a disclaimer may not be used to avoid an adverse opinion.

Paragraphs that do not change the opinion

Paragraph	Used for	Examples
Emphasis-of-matter (EOM)	A matter **appropriately presented or disclosed** in the statements that is fundamental to users' understanding	**Required**: change in accounting principle with material effect; correction of a material misstatement in previously issued statements; special purpose framework (describes the basis); revised statements after subsequently discovered facts. **Optional**: major catastrophe, significant uncertainty, significant related-party transactions
Other-matter (OM)	A matter **not presented or disclosed** in the statements that is relevant to users' understanding of the audit, the auditor's responsibilities or the report	Restriction on use or distribution; predecessor auditor audited the prior year (report not reissued); **required supplementary information** (RSI) omitted or not reviewed; prior-period statements were reviewed/compiled or not audited

The EOM refers only to information in the statements; it may not be used instead of a modified opinion, or for a matter that is not disclosed.

Consistency

A change in accounting principle (or correction of an error) with a **material effect** requires an EOM (nonissuer) or explanatory paragraph (issuer), in the period of change and later periods presented. A change in **estimate** does not. If the change is not justified or not properly accounted for, it is a misstatement → qualified or adverse.

Comparative statements

The opinion covers **each period** presented. The auditor **updates** the opinion on prior statements audited by the same firm, and may express **different opinions** on different periods (for example, qualified on the prior year, unmodified on the current year, with an OM explaining a changed prior opinion).

If a **predecessor** audited the prior year and its report is **not reissued**, the successor's report includes an **other-matter paragraph** stating that another auditor audited the prior statements, the date and type of its opinion, and the reasons for any modification. If the predecessor **reissues** its report, it reads the current statements, compares them with the prior ones, and obtains a **representation letter** from the successor and management; the reissued report keeps its original date (or is dual dated if revised).

Other information, supplementary information and RSI

Item	Auditor's responsibility	Report
Other information (annual report, e.g., MD&A, letter to shareholders) — AU-C 720	**Read** and consider material inconsistencies with the statements or the auditor's knowledge	Separate "Other Information" section; no opinion
Supplementary information (consolidating schedules, schedule of expenses) — AU-C 725	Perform procedures (agree to records, compare with statements)	Opinion on whether it is fairly stated **"in relation to"** the statements as a whole — in an OM paragraph or separate report
Required supplementary information (RSI, e.g., GASB MD&A) — AU-C 730	Limited procedures (inquiry, comparison)	**Always** an OM paragraph: states it is required, that limited procedures were applied, and that no opinion is expressed; also notes omissions or departures

Special reports

Engagement	Key reporting features
Special purpose frameworks — cash, tax, regulatory, contractual basis (AU-C 800)	Statements titled to avoid GAAP terms (e.g., "statement of assets and liabilities arising from cash transactions"); **EOM** describing the basis and that it differs from GAAP; **OM restricting use** when the framework is regulatory or contractual (unless a general-use regulatory framework)
Single statement or specific element, account or item (AU-C 805)	Materiality set for the element; may be separate engagement or part of the audit
Compliance with contractual or regulatory requirements in connection with an audit (AU-C 806)	**Negative assurance** ("nothing came to our attention") on compliance, given in a separate report or paragraph; use restricted

Worked examples

Example: Choosing the opinion. For a nonissuer, decide each case:

1. Leases of $2.1 million are omitted from the balance sheet; materiality is $300,000; the effect is confined to assets and liabilities. **Qualified** (misstatement, material, not pervasive).
2. Records for the main subsidiary, 70% of assets, were destroyed and cannot be reconstructed. **Disclaimer** (scope limitation, pervasive).
3. Management refuses to record any expected credit losses, and the misstatement affects receivables, income, equity and covenant disclosures throughout. **Adverse** (misstatement, pervasive).
4. The auditor could not observe inventory of $400,000 (materiality $300,000) and no alternative procedures were possible. **Qualified** for the possible effects.

Example: EOM or OM? (1) A properly disclosed change from FIFO to weighted-average with material effect → **EOM** (required). (2) The prior year was audited by a predecessor whose report is not reissued → **OM**. (3) The report is restricted to the lender because the statements follow a contractual basis → **OM**. (4) A properly disclosed hurricane after year-end that the auditor wishes to highlight → **EOM** (optional).

Common traps

- Using an EOM paragraph for something not disclosed in the statements.
- Choosing adverse for a scope limitation, or disclaimer for a misstatement.
- Thinking KAMs are required for every nonissuer audit — only when engaged.
- Putting the opinion section after the basis section (opinion comes first).

Key takeaways

- Nonissuer order: Opinion, Basis for Opinion, going concern, KAMs (if engaged), management responsibilities, auditor responsibilities, other information, signature, location, date.
- Issuer report: PCAOB standards, SEC/PCAOB independence, CAMs, tenure.
- Misstatement: material → qualified; pervasive → adverse. Scope: material → qualified; pervasive → disclaimer.
- EOM = disclosed matter (required for change in principle, error correction, special purpose framework); OM = undisclosed matter (restricted use, predecessor, RSI).
- Supplementary information gets an "in relation to" opinion; RSI gets an OM paragraph with no opinion.

16. Reviews & Compilations (SSARS)

Many private companies do not need an audit. A lender may accept reviewed or compiled statements, and a small business may just want statements prepared. The **Statements on Standards for Accounting and Review Services (SSARS)**, codified as **AR-C** sections and issued by the AICPA's Accounting and Review Services Committee, govern these engagements for **nonissuers**. AUD tests the differences among the three services, review procedures and the content of reports.

The three SSARS services at a glance

Feature	Preparation (AR-C 70)	Compilation (AR-C 80)	Review (AR-C 90)
Assurance	**None**	**None**	**Limited**
Report	**None required**; each page states that **no assurance is provided** (or a disclaimer is issued)	**Required**	**Required**
Independence	Not required (need not be disclosed)	Not required, but **lack of independence must be disclosed** in the report	**Required**
Engagement letter	Required, signed by accountant and management	Required	Required
Procedures	Prepare statements from records and information provided	Read the statements for obvious material misstatements	**Analytical procedures and inquiries**, plus a representation letter
Understanding of the entity	Framework and significant policies	Framework and significant policies	More: industry, business, accounting principles and practices
Omit substantially all disclosures?	**Allowed** (disclose the omission)	**Allowed** (disclose in the report)	**Not allowed**
Representation letter	Not required	Not required	**Required**, dated as of the report date

> **Memory trick:** "**Prep, Comp, Review = Zero, Zero, Limited.**" Only the review gives assurance, and only the review requires independence.

All three are performed when the accountant is **engaged** to do them. A CPA who merely helps the client with bookkeeping and then is asked to prepare statements decides whether the engagement is a preparation engagement. AR-C 60 (general principles) applies to all.

Preparation engagements (AR-C 70)

The accountant prepares the financial statements (including prospective statements or pro forma information) under a framework. Requirements:

- An engagement letter describing the objectives, management's responsibilities (including for internal control and for the accuracy of records), the accountant's responsibilities and the limitations.
- Each page of the statements must include a statement that **"no assurance is provided"**. If the accountant cannot include it, the accountant must issue a disclaimer or not perform the engagement.
- Statements prepared under a **special purpose framework** must describe the framework; material GAAP departures must be disclosed.
- If the accountant becomes aware that records are incomplete or inaccurate, the accountant asks management for additional information; if not provided, the accountant withdraws.

Compilation engagements (AR-C 80)

The accountant assists management in presenting financial information in the form of statements without obtaining or providing assurance. The accountant **reads** the statements for obvious material misstatements, and if records seem incomplete or inaccurate, requests revised information.

Compilation report elements

Element	Content (plain words)
Statement of management's responsibility	Management is responsible for the statements
Identification of the statements	Entity, statements and dates or periods
What the accountant did	Performed a compilation engagement under SSARS
No assurance	The accountant did not audit or review the statements, is not required to verify the information, and **does not express an opinion, a conclusion, or provide any form of assurance**
Signature, city and state, date	Report dated when the compilation is completed

The report has **no title requirement** and is addressed as appropriate. Additional paragraphs when applicable:

- **Lack of independence**: a final paragraph stating the accountant is not independent. The accountant **may** give the reasons; if so, **all** reasons must be given.
- **Omission of substantially all disclosures**: state that management elected to omit them and that, if included, they might influence users.
- **GAAP departures** known to the accountant: describe them (and effects if known), or withdraw if the departure is intended to mislead.
- **Special purpose framework**: refer to the note describing it if disclosures do not.
- **Supplementary information** and RSI: state the accountant's responsibility, if any.

Review engagements (AR-C 90)

A review gives **limited assurance** that the accountant is not aware of any material modifications that should be made for the statements to conform with the framework. It is substantially less in scope than an audit: the accountant **does not** obtain an understanding of internal control, assess fraud risk, test records, confirm balances, observe inventory or obtain corroborating evidence beyond what the procedures require.

Review procedures

1. **Understanding** of the industry and the entity's business and accounting practices.
2. **Analytical procedures**: compare with prior periods and expectations, consider relationships among elements, develop expectations, and investigate significant differences.

3. **Inquiries** of management with responsibility for financial and accounting matters — about principles and practices, procedures for recording transactions, unusual or complex situations, significant journal entries, subsequent events, fraud, going concern, related parties, litigation, and actions taken at board meetings.
4. **Reconcile** the statements to the underlying accounting records.
5. Obtain a **representation letter** from management covering **all periods** presented, dated as of the **report date**.
6. Read the statements for conformity with the framework; consider **going concern** (and include an emphasis-of-matter paragraph if substantial doubt exists).

If the accountant becomes aware that information may be incorrect, incomplete or unsatisfactory, the accountant performs **additional procedures**. If the accountant cannot complete the review (for example, management refuses to provide the representation letter), the accountant **withdraws** — there is no "qualified review."

Review report

Section	Content (plain words)
Title	Includes the word "independent"
Introductory paragraph	Identifies the entity and statements reviewed; explains a review consists principally of **analytical procedures** applied to management's financial data and **inquiries** of management; says it is substantially less in scope than an audit and **no opinion** is expressed
Management's responsibility	Preparation and fair presentation, and internal control relevant to them
Accountant's responsibility	Review conducted under SSARS; standards require procedures to obtain limited assurance; the accountant believes the results provide a reasonable basis; the accountant is required to be independent and meet ethical responsibilities
Accountant's conclusion	Based on the review, the accountant is **not aware of any material modifications** that should be made for the statements to conform with the framework
Signature, city and state, date	Dated no earlier than when sufficient review evidence was obtained

For a known **GAAP departure**, the review report is modified with a "Basis for Qualified Conclusion" or "Basis for Adverse Conclusion" — the accountant describes the departure and its effects. A review conclusion never uses the words "in our opinion."

Interim reviews for audit clients

Engagement	Standard
Review of interim financial information of a **nonissuer** by its **auditor** (who has audited the latest annual statements)	**AU-C 930**
Review of interim (quarterly) information of an **issuer**	**PCAOB AS 4105**
Review of interim information by an accountant who is **not** the entity's auditor (nonissuer)	**SSARS** (AR-C 90)

AU-C 930 and AS 4105 reviews consist mainly of analytical procedures and inquiries, but the accountant has a stronger base of knowledge from the audit, including of internal control.

Worked examples

Example: Choosing the service. Omar's client needs (1) monthly statements for internal use only, with no report; (2) annual statements for a bank that requires "some assurance but not an audit"; and (3) annual statements for a supplier who wants a CPA's report but no assurance.

- (1) **Preparation** — no report; each page says no assurance is provided.
- (2) **Review** — limited assurance; Omar must be independent.
- (3) **Compilation** — report required; if Omar is not independent he may still do it but must disclose the lack of independence.

Example: Independence in a compilation. The accountant's spouse owns 8% of the client. The accountant wants to explain why she is not independent.

- A compilation is allowed; the report must include a final paragraph stating she is not independent.
- Giving reasons is optional; since she chooses to, she must include **all** reasons (here, the spouse's ownership).
- She could **not** perform a review or audit for this client.

Example: Refused representation letter in a review. At the end of a review, management refuses to sign the representation letter.

- A representation letter is required in a review.
- The accountant cannot issue a review report and must **withdraw**. A refusal to sign the representation letter ordinarily also prevents the accountant from "stepping down" to a compilation of the same statements; a change of engagement is appropriate only for a valid reason (such as a change in the client's needs), and any new report may not refer to the review.

Common traps

- Saying a compilation provides limited assurance.
- Using "in our opinion" in a review report.
- Believing a preparation engagement always requires a report.
- Allowing omission of substantially all disclosures in a review.
- Thinking the accountant tests internal control in a review.

Key takeaways

- Preparation: no assurance, no report, "no assurance is provided" on each page, independence not required.
- Compilation: no assurance, report required, lack of independence disclosed (reasons optional, all if any).
- Review: limited assurance, independence required, analytics plus inquiries plus representation letter dated as of the report date; conclusion "not aware of any material modifications."
- Omitting substantially all disclosures is allowed in preparation and compilation, not review.
- Interim reviews: AU-C 930 (nonissuer, entity's auditor), AS 4105 (issuer).

17. Attestation & Agreed-Upon Procedures

Attestation engagements apply audit-style skills to subject matter other than historical financial statements: internal control, compliance, greenhouse gas emissions, royalty schedules, forecasts, cybersecurity programs. The **Statements on Standards for Attestation Engagements (SSAEs)**, codified as **AT-C** sections, govern them for nonissuers. AUD tests the three levels of service, the conditions for an engagement (criteria, independence, assertions), report content, and the special rules for agreed-upon procedures and prospective financial information.

The three attestation services

Feature	Examination (AT-C 205)	Review (AT-C 210)	Agreed-upon procedures (AT-C 215)
Assurance	**Reasonable** (high)	**Limited** (moderate)	**None** — findings only
Conclusion	**Opinion**	**Conclusion** that the practitioner is not aware of material modifications	**Procedures and findings**; no opinion, conclusion or negative assurance
Typical procedures	All types, including tests of details and controls	Mainly **inquiry and analytical procedures**	Specific procedures agreed with the engaging party
Independence	**Required**	**Required**	**Required**
Report use	General use (may be restricted)	General use (may be restricted)	General use allowed (SSAE 19); practitioner may restrict

Exam tip: Independence is required for **all three** attestation services, including AUP. That is a favorite trap.

Parties and preconditions

Party	Role
Responsible party	Responsible for the subject matter (usually management)
Engaging party	Engages the practitioner (often the responsible party, but can be someone else, such as a regulator or buyer)
Practitioner	The CPA performing the engagement
Intended users	Those for whom the report is prepared

Preconditions for accepting an attestation engagement:

- The practitioner is **independent**.
- The responsible party takes responsibility for the subject matter (or, in an examination or review where the engaging party is not the responsible party, the responsible party's responsibility is acknowledged).
- The **subject matter is appropriate** — identifiable and capable of consistent measurement against criteria.
- The **criteria are suitable** and **available** to intended users.
- The practitioner expects to obtain the evidence needed and that the engagement has a rational purpose.

Suitable criteria

Characteristic	Meaning	Failure example
Relevance	Results in information that helps users make decisions	Criteria measure office supply use for an environmental program
Objectivity	Free from bias	Criteria chosen because they always show improvement
Measurability	Permit reasonably consistent measurement	"Quality is whatever the manager feels is excellent"
Completeness	No relevant factors omitted	Emissions criteria leave out a major source

Criteria must also be **available** to users — publicly, in the presentation, in the report, or understood by users (for example, a contract's terms). If criteria are available only to specified parties, the report is **restricted** to them.

> **Memory trick:** "**ROMC**" — Relevant, Objective, Measurable, Complete.

Assertions and direct engagements

In an **assertion-based** examination or review, the practitioner reports on the subject matter or on the responsible party's **written assertion** about it. The practitioner requests a written assertion; if the engaging party **is** the responsible party and refuses to provide one, the practitioner **withdraws** from an examination when withdrawal is possible under law or regulation. If the engaging party is **not** the responsible party, the refusal is disclosed in the report.

SSAE No. 21 introduced **direct examination engagements** (AT-C 206), in which the practitioner measures or evaluates the subject matter against the criteria directly and no assertion is required, and revised the examination report structure. Direct engagements are examinations only.

Examination report elements

Element	Content (plain words)
Title with "independent"	
Identification	The subject matter (or assertion), the period or date, the responsible party, and the criteria
Responsibilities	The responsible party is responsible for the subject matter; the practitioner is responsible for expressing an opinion based on the examination
Standards	Conducted under AICPA attestation standards; reasonable assurance; procedures described; the practitioner believes the evidence is sufficient and appropriate; independence and ethics met
Inherent limitations	When applicable (for example, controls may become inadequate)
Opinion	Whether the subject matter is presented in accordance with (or based on) the criteria, in all material respects (or whether the assertion is fairly stated)
Restriction on use	When required (criteria available only to specified parties, etc.)
Signature, city and state, date	

A review report has the same structure but states a review is substantially less in scope than an examination and gives a **conclusion** (not aware of material modifications). Modified opinions in examinations parallel audits: qualified, adverse or disclaimer.

Agreed-upon procedures (SSAE No. 19)

In an AUP engagement, the practitioner performs **specific procedures** on subject matter and reports the **findings**. SSAE 19 modernized AUP:

- The **engaging party acknowledges that the procedures are appropriate** for the intended purpose (other parties no longer have to take responsibility for the sufficiency of procedures).
- The report may be for **general use**; the practitioner may restrict it (for example, when other parties do not understand the procedures).
- Procedures may be developed or modified during the engagement, and the practitioner may assist in developing them.
- A written assertion is **not** required (it may be requested).

Procedures must be **specific** and produce **objective** findings. Terms such as "general review," "limited review," "check," "test" or "evaluate" without definition, or procedures requiring the practitioner's subjective judgment, are not acceptable — the practitioner should decline as stated and work with the engaging party to define a specific procedure. A procedure such as "compare," "agree," "recompute," "inspect" with stated criteria is acceptable.

AUP report

Element	Content (plain words)
Title with "independent"	
Engaging party, subject matter, purpose	Including that the engaging party acknowledged the procedures are appropriate
Statement that procedures may not address users' needs	Users are responsible for determining whether the procedures meet their purposes
List of **procedures and findings**	Factual, including exceptions; no subjective words like "fairly," "adequate"
No opinion or conclusion	The practitioner was not engaged to and did not perform an examination or review; had additional procedures been performed, other matters might have been reported
Independence	Statement that the practitioner is independent
Restriction (if applicable), signature, city and state, date	

Prospective financial information (AT-C 305 and related)

Type	Based on	Use
Forecast	Management's **expected** conditions and course of action	**General use** or limited use
Projection	One or more **hypothetical** assumptions ("what if we build a new plant")	**Limited use** — only parties negotiating **directly** with the responsible party

Services allowed on prospective information: **examination** (opinion on presentation under AICPA guidelines and on whether assumptions provide a **reasonable basis**), **compilation**, and **agreed-upon procedures**. A **review** of prospective financial information is **not** permitted. Every report states that results may not be achieved because events often do not occur as expected, and that the practitioner has no responsibility to update the report.

Other attestation subjects

- **Examination of ICFR** integrated with an audit (AT-C 205 for nonissuers).
- **Compliance attestation** (AT-C 315): examination or AUP on compliance with laws, regulations, contracts or grants, or on controls over compliance. A review of compliance is **not** allowed.
- **Service organization controls** (SOC 1 under AT-C 320; SOC 2 under AT-C 205; Chapter 13).
- **Pro forma financial information** (AT-C 310): examination or review of pro forma adjustments.

Worked examples

Example: Acceptable AUP procedure? The engaging party proposes three procedures:

1. "Review the royalty schedule for reasonableness." **Not acceptable** — subjective; ask the party to specify, e.g., "recompute royalties as units sold × rate in the license agreement."
2. "Agree units sold in the royalty schedule to the shipping register for the year." **Acceptable** — specific with an objective result.
3. "Evaluate whether internal controls over royalties are adequate." **Not acceptable** in AUP — calls for a judgment conclusion; consider an examination instead.

Example: Forecast or projection? A company asks for an examination of financial statements that assume a new plant will be built "if the bond issue succeeds." The assumption is hypothetical → **projection**. The report is limited to parties negotiating directly with the company (for example, the prospective bondholders' representatives). A review of it would not be allowed.

Common traps

- Thinking AUP engagements don't require independence.
- Allowing a review of prospective financial information or of compliance.
- Confusing forecasts (expected conditions) with projections (hypothetical assumptions).
- Accepting vague AUP procedures ("review," "check") or reporting negative assurance in an AUP report.
- Forgetting that SSAE 19 allows general-use AUP reports.

Key takeaways

- Examination = reasonable assurance and opinion; review = limited assurance and conclusion; AUP = procedures and findings. Independence required for all.
- Suitable criteria: relevant, objective, measurable, complete — and available to users.
- Responsible party refuses an assertion (and is the engaging party) → withdraw from an examination when possible.
- SSAE 19: engaging party acknowledges appropriateness; general-use AUP reports allowed; procedures must be specific and objective.
- SSAE 21: direct examination engagements without an assertion.
- Prospective information: examination, compilation or AUP — never a review; projections are limited use.

18. Government & Single Audits

Governments, school districts, universities and not-for-profits that spend federal money are audited under extra rules. **Government Auditing Standards (GAGAS)** — the "Yellow Book" issued by the U.S. **Government Accountability Office (GAO)** — add requirements on top of GAAS. When an entity spends enough federal award money, it also needs a **single audit** under the **Uniform Guidance (2 CFR 200 Subpart F)** issued by the **Office of Management and Budget (OMB)**. AUD tests who issues what, the added GAGAS requirements, major program determination and the single audit reports.

Three layers of standards

Layer	Issued by	Adds
GAAS (AU-C)	AICPA ASB	The base audit of financial statements
GAGAS (Yellow Book, 2024 revision)	**GAO**	Independence, CPE, quality management, peer review, reporting on internal control and compliance
Single Audit (Uniform Guidance, 2024 revision)	**OMB**	Audit of major federal programs, opinion on compliance, schedule of findings and questioned costs

Each layer includes the ones below it. A single audit is performed under GAAS **and** GAGAS **and** the Uniform Guidance.

> **Watch out:** GAO issues GAGAS; OMB issues the Uniform Guidance. The exam swaps them.

GAGAS engagement types

Type	Description
Financial audit	Opinion on financial statements (and related reports on internal control and compliance)
Attestation engagement	Examination, review or AUP on subject matter or an assertion
Review of financial statements	SSARS review plus GAGAS requirements
Performance audit	Findings and conclusions about program **effectiveness, efficiency, economy**, internal control, compliance or prospective analysis, against criteria

Key GAGAS requirements

Area	Requirement
Ethics	Public interest, integrity, objectivity, proper use of government information, professional behavior
Independence	Conceptual framework with threats including **bias** and **structural** (Chapter 2); assess management's skill, knowledge or experience to oversee any nonaudit service and document it
CPE	**80 hours every 2 years**, with at least **24 hours** directly related to government auditing, the government environment or the specific environment of the audited entity (and at least 20 hours in each year of the period, for auditors who plan, direct, perform or report)
Quality management	A system of quality management (the 2024 Yellow Book aligns with SQMS) — in place by **December 15, 2025**
Peer review	External peer review at least once every **3 years**
Reporting	The auditor's report states the audit followed GAGAS

Additional financial audit reporting under GAGAS

In addition to the opinion on the financial statements, the auditor issues a **report on internal control over financial reporting and on compliance** with provisions of laws, regulations, contracts and grant agreements. That report:

- describes the **scope** of testing of internal control and compliance,
- states whether the tests provided sufficient evidence to support an **opinion** on internal control or compliance — under a financial audit they **do not**, so **no opinion** is given on ICFR or compliance,

- reports **significant deficiencies and material weaknesses**, and **instances of noncompliance** or fraud that are material, and
- includes **views of responsible officials** and planned corrective actions.

GAGAS also requires reporting of fraud, noncompliance and abuse that warrant attention, and in some cases reporting directly to outside parties if the entity fails to.

Abuse is behavior that is deficient or improper compared with what a prudent person would consider reasonable and necessary business practice — it may not involve fraud or noncompliance.

The single audit (Uniform Guidance, Subpart F)

Who needs one

Federal awards expended in the fiscal year	Requirement
$1,000,000 or more (fiscal years beginning on or after **October 1, 2024**)	**Single audit** — or a **program-specific audit** if the entity expends awards under only one program and the program's rules do not require a financial statement audit
Less than $1,000,000	Exempt from a single audit, but records must be available for review

Non-federal entities covered: states, local governments, Indian tribes, institutions of higher education and nonprofit organizations. (For-profit entities follow award terms.)

The **auditee** chooses the auditor through procurement standards; the audit generally covers the entity's fiscal year.

Determining major programs — the risk-based approach

Step	What happens
1	Identify **Type A** programs: federal programs with expenditures above the **Type A threshold** — **$1,000,000** when total federal expenditures are **$34 million or less** (a sliding scale applies to larger auditees)
2	Identify **low-risk Type A** programs: audited as a major program in at least one of the two most recent audit periods, with no significant findings (such as material weaknesses, modified compliance opinions, or known or likely questioned costs over 5% of program expenditures)
3	Assess **Type B** programs (those below the Type A threshold) for risk — only those **above 25%** of the Type A threshold. The auditor need not assess more high-risk Type B programs than **one-fourth** of the number of low-risk Type A programs
4	Major programs = all **high-risk Type A** programs + **high-risk Type B** programs identified, then add programs as needed to meet the **percentage-of-coverage rule**

Coverage rule	Major programs must cover at least...
Regular auditee	**40%** of total federal awards expended
Low-risk auditee	**20%**

A **low-risk auditee** has had single audits for each of the preceding **two** years with unmodified opinions on the statements and on major program compliance, no material weaknesses in internal control over major programs, no going concern substantial doubt, and Type A programs without certain findings.

Example: Major program coverage. A county expended $12,000,000 of federal awards. It is not a low-risk auditee.

- Total expenditures are below $34 million, so the Type A threshold is **$1,000,000**.
- Type B programs are risk-assessed only if above 25% × $1,000,000 = **$250,000**.
- Coverage: major programs must total at least 40% × $12,000,000 = **$4,800,000**. If the risk-based selection covers only $3,900,000, the auditor adds programs until coverage reaches $4,800,000.
- If the county were a low-risk auditee, the coverage minimum would be 20% × $12,000,000 = **$2,400,000**.

Materiality and compliance requirements

Materiality for compliance is determined **separately for each major program**. The auditor tests compliance with the **compliance requirements** identified in the OMB **Compliance Supplement** (for example, activities allowed, allowable costs, eligibility, cash management, reporting, procurement, subrecipient monitoring), and tests **internal**

control over compliance for major programs to support a **low** assessed level of control risk (planning to rely on controls).

Reports and schedules

Report or schedule	Prepared by	Content
Financial statements	Auditee	
Schedule of expenditures of federal awards (SEFA)	**Auditee**	Federal expenditures by program, with Assistance Listing numbers
Summary schedule of prior audit findings	**Auditee**	Status of prior findings
Corrective action plan	**Auditee**	Planned actions for current findings
Opinion on the financial statements and an **"in relation to" opinion on the SEFA**	Auditor	
Report on internal control over financial reporting and on compliance (GAGAS)	Auditor	No opinion
Report on compliance for each major program and on internal control over compliance	Auditor	**Opinion on compliance** for each major program; internal control over compliance reported without an opinion
Schedule of findings and questioned costs	**Auditor**	Summary of results (opinions, major programs, thresholds, low-risk status), financial statement findings, and federal award findings and **questioned costs** (likely questioned costs over **$25,000** for a compliance requirement must be reported)

Deadlines

The auditee submits the **data collection form** and the **reporting package** to the **Federal Audit Clearinghouse** by the **earlier** of **30 calendar days** after receiving the auditor's reports or **9 months** after the end of the audit period.

Other parties' roles

Party	Responsibility
Auditee	Prepares statements, SEFA, prior findings summary and corrective action plan; follows up on findings; submits the reporting package
Auditor	Performs the audit, determines major programs, issues opinions and reports, prepares the schedule of findings and questioned costs
Federal awarding agency	Issues **management decisions** on findings; provides compliance requirements through OMB
Pass-through entity	Passes awards to **subrecipients**; monitors them and verifies that subrecipients expending $1,000,000 or more have the required audits
Cognizant / oversight agency for audit	Provides technical audit advice and coordinates; cognizant agency assigned for auditees expending more than $50 million a year

Worked example

Example: Which report says what? In a single audit of a school district:

1. "In our opinion, the district complied, in all material respects, with the compliance requirements that could have a direct and material effect on each of its major federal programs." → **Report on compliance for each major program** (opinion).
2. A statement that tests of internal control over financial reporting were not designed to express an opinion on it, followed by a listing of a significant deficiency. → **GAGAS report on internal control over financial reporting and on compliance** (no opinion).
3. A $31,000 likely questioned cost for unallowable travel charged to a major program. → **Schedule of findings and questioned costs** (above the $25,000 reporting threshold).
4. The district's plan to retrain grant staff. → **Corrective action plan**, prepared by the auditee.

Common traps

- Using the old **$750,000** thresholds — the single audit and Type A thresholds are now **$1,000,000**.
- Thinking the GAGAS report on internal control over financial reporting contains an opinion.
- Confusing GAO (GAGAS) with OMB (Uniform Guidance).
- Assigning the SEFA or corrective action plan to the auditor.
- Applying the 40% coverage rule to a low-risk auditee (20%).

Key takeaways

- GAAS → GAGAS (GAO) → Uniform Guidance (OMB); a single audit follows all three.
- GAGAS: 80 hours CPE every 2 years (24 government-related), quality management by December 15, 2025, peer review every 3 years, additional report on internal control and compliance with no opinion.
- Single audit when federal expenditures are $1,000,000 or more (fiscal years beginning on or after October 1, 2024).
- Type A threshold $1,000,000 (up to $34 million total); Type B assessed if above 25% of Type A threshold; coverage 40% (20% low-risk auditee).
- Auditee prepares SEFA, summary of prior findings and corrective action plan; auditor issues opinions and the schedule of findings and questioned costs.
- Reporting package due the earlier of 30 days after receiving reports or 9 months after year-end.

Final Review Checklist

Use this checklist in the last week before the exam. Tick each item only when you can do it **without notes**. Any item you cannot tick sends you back to its chapter and to the matching bank chapter for a fresh set of questions.

Ethics, independence and quality (Chapters 1–3)

☐ I can name the Code's parts (public practice, business, other) and the seven threats in the conceptual framework.

☐ I know when contingent fees and commissions are prohibited and when disclosure is required.

☐ I can sort records into client-provided, member-prepared, work products and working papers, and say which must be returned.

☐ I know the confidentiality exceptions and the designated accounting bodies (FASB, GASB, FASAB, IASB).

☐ I can identify covered members and apply the direct/indirect financial interest and 5% rules.

☐ I know the permitted loans ($10,000 credit card limit) and the one-year unpaid fee rule.

☐ I can list the SOX prohibited services, rotation rules (5/5 and 7/2) and the one-year cooling-off.

☐ I can name the GAGAS threats, including bias and structural.

☐ I can name the eight SQMS No. 1 components and the EQ reviewer's two-year cooling-off.

☐ I know documentation deadlines: AICPA 60 days / 5 years; PCAOB 14 days / 7 years.

Planning and risk (Chapters 4–7)

☐ I know the preconditions for an audit and the required engagement letter elements (fees are not required).

☐ I know the required predecessor inquiries and that working paper review is optional and after acceptance.

☐ I can distinguish the overall audit strategy from the audit plan.

☐ I know what to communicate to those charged with governance, including resolved disagreements.

☐ I can apply the inherent risk factors and identify significant risks under SAS No. 145.

☐ I can classify fraud risk factors into the fraud triangle and list the three responses to management override.

☐ I know which fraud presumption is rebuttable (revenue) and which is not (management override).

☐ I can name the five COSO components and spot segregation-of-duties failures.

☐ I can classify a deficiency as a deficiency, significant deficiency or material weakness, and know the 60-day communication rule.

☐ I know that any material weakness gives an adverse ICFR opinion under AS 2201.

☐ I can compute overall materiality, performance materiality and the clearly trivial threshold.

☐ I can compute DR = AR ÷ (IR × CR) and explain its effect on substantive procedures.

Evidence and sampling (Chapters 8–9)

☐ I can rank evidence by reliability and match assertions to procedures (vouch for existence, trace for completeness).

☐ I know the conditions for negative confirmations and the response to nonresponses.

☐ I can name the three approaches to auditing estimates and measure a misstatement to the nearest end of a range.

☐ I know how to handle a lawyer's refusal to respond.

☐ I can state how each factor changes sample size.

☐ I can compute attribute sample size and the upper deviation limit, and decide whether to rely on a control.

☐ I can compute the MUS interval, sample size, projected misstatements and upper misstatement limit.

☐ I can compute MPU, difference and ratio estimates.

Account areas and analytics (Chapters 10–12)

☐ I can prepare a bank reconciliation and know which items need journal entries.

☐ I can detect kiting with an interbank transfer schedule and lapping with remittance comparisons.

☐ I know when receivables confirmation may be skipped and what to document.

☐ I can apply FOB terms and consignment rules to revenue cutoff and inventory ownership.

☐ I know the direction of inventory test counts and the search for unrecorded liabilities.

☐ I can recalculate straight-line and double-declining-balance depreciation, including partial years.

☐ I know when analytical procedures are required and the four steps of a substantive analytical procedure.

☐ I can compute the current, quick, receivable turnover, days sales, inventory turnover and gross margin ratios.

Others, completion and reporting (Chapters 13–15)

☐ I can evaluate internal audit (objectivity, competence, systematic approach) and know the limits on direct assistance.

☐ I know the difference between SOC 1 Type 1 and Type 2, and SOC 2 and SOC 3.

☐ I know the conditions for making reference to a component auditor and that it is not a qualification.

☐ I can classify subsequent events as recognized or nonrecognized and explain dual dating.

☐ I know the procedures for subsequently discovered facts and omitted procedures.

☐ I can choose the going concern reporting outcome.

☐ I know the representation letter date, signers and the effect of refusing fundamental representations.

☐ I can list the sections of the nonissuer and issuer reports in order.

☐ I can apply the opinion grid: misstatement (qualified/adverse) versus scope limitation (qualified/disclaimer).

☐ I can choose between emphasis-of-matter and other-matter paragraphs.

☐ I know the reporting for supplementary information ("in relation to") and RSI (other-matter, no opinion).

Other engagements (Chapters 16–18)

☐ I can compare preparation, compilation and review on assurance, report, independence and disclosures.

☐ I know the review procedures and that a review report uses a conclusion, not an opinion.

☐ I can compare examination, review and AUP, and know that all three require independence.

☐ I can name the characteristics of suitable criteria and identify acceptable AUP procedures.

☐ I know the rules for forecasts and projections and that a review of prospective information is not allowed.

☐ I know the GAGAS CPE rule and the additional report on internal control and compliance.

☐ I can determine Type A and Type B programs and apply the 40% / 20% coverage rule.

☐ I know who prepares each single audit schedule and the reporting package deadline.

Key numbers at a glance

Item	Number
AUD exam	4 hours; 78 MCQs; 7 TBSs; passing score 75
Records return	45 days generally reasonable
Covered member nonattest hours	10 or more hours
Ownership by any partner or professional employee	More than 5% impairs independence
Credit card balance	$10,000 or less by the due date
Unpaid fees	More than one year before the current report date
SEC rotation	Lead and EQR partners 5 on / 5 off; other audit partners 7 on / 2 off
Cooling-off (issuer financial reporting oversight role)	One year
EQ reviewer cooling-off (former engagement partner)	Two years
Documentation	AICPA 60 days / 5 years; PCAOB 14 days / 7 years
Peer review	Every 3 years
Control deficiency communication	No later than 60 days after report release
Tests of unchanged controls	At least every third audit
Poisson factors, 95%	0: 3.00; 1: 4.74; 2: 6.30; 3: 7.75
MUS expansion factors	1.6 (5% risk); 1.5 (10% risk)
Going concern look-forward (GAAP)	One year after statements are issued or available to be issued
GAGAS CPE	80 hours every 2 years, 24 government-related
Single audit threshold	$1,000,000 of federal awards expended
Type A threshold	$1,000,000 (total expenditures up to $34 million)
Type B risk assessment	Above 25% of the Type A threshold
Major program coverage	40%; 20% for low-risk auditees
Questioned costs reported	Likely questioned costs over $25,000
Reporting package due	Earlier of 30 days after reports or 9 months after year-end

The night before the exam

- Reread the **Key takeaways** at the end of each chapter.
- Redraw the opinion grid and the order of report sections from memory.
- Run one attribute sample and one MUS evaluation by hand.
- Plan your time: about 1.3–1.5 minutes per MCQ, the rest for simulations.
- Sleep. A rested mind spots "which standard applies?" traps faster.

> **Exam tip:** When two answers look right, check three things: **who** the client is (issuer or not), **what** the engagement is (audit, review, compilation, examination, AUP, single audit), and **which** document the answer belongs in (opinion, basis section, EOM, OM, management letter, representation letter). Most distractors are correct statements placed under the wrong standard or in the wrong document.

Now practice it

Every chapter in this guide has matching practice tests, simulations and mock exams at **UPractice.org**.