

PART

[5]

COMPLETING THE
AUDIT, REPORTING,
AND OTHER SERVICES

19

COMPLETING THE AUDIT AND POSTAUDIT RESPONSIBILITIES

AUDITOR'S RESPONSIBILITIES FOR EVENTS OCCURRING AFTER BALANCE SHEET DATE

On February 6, 2002, PriceWaterhouseCoopers LLP issued an unqualified opinion on the financial statements of Adolph Coors Company for the years ended December 30, 2001, and December 31, 2000. The balance sheet showed total assets of approximately \$1.7 billion, current liabilities of approximately \$0.5 billion, long-term liabilities of approximately \$0.25 billion, and shareholders' equity of approximately \$0.95 billion. Net income was approximately \$123 million, and cash flow from operations was approximately \$193 million.

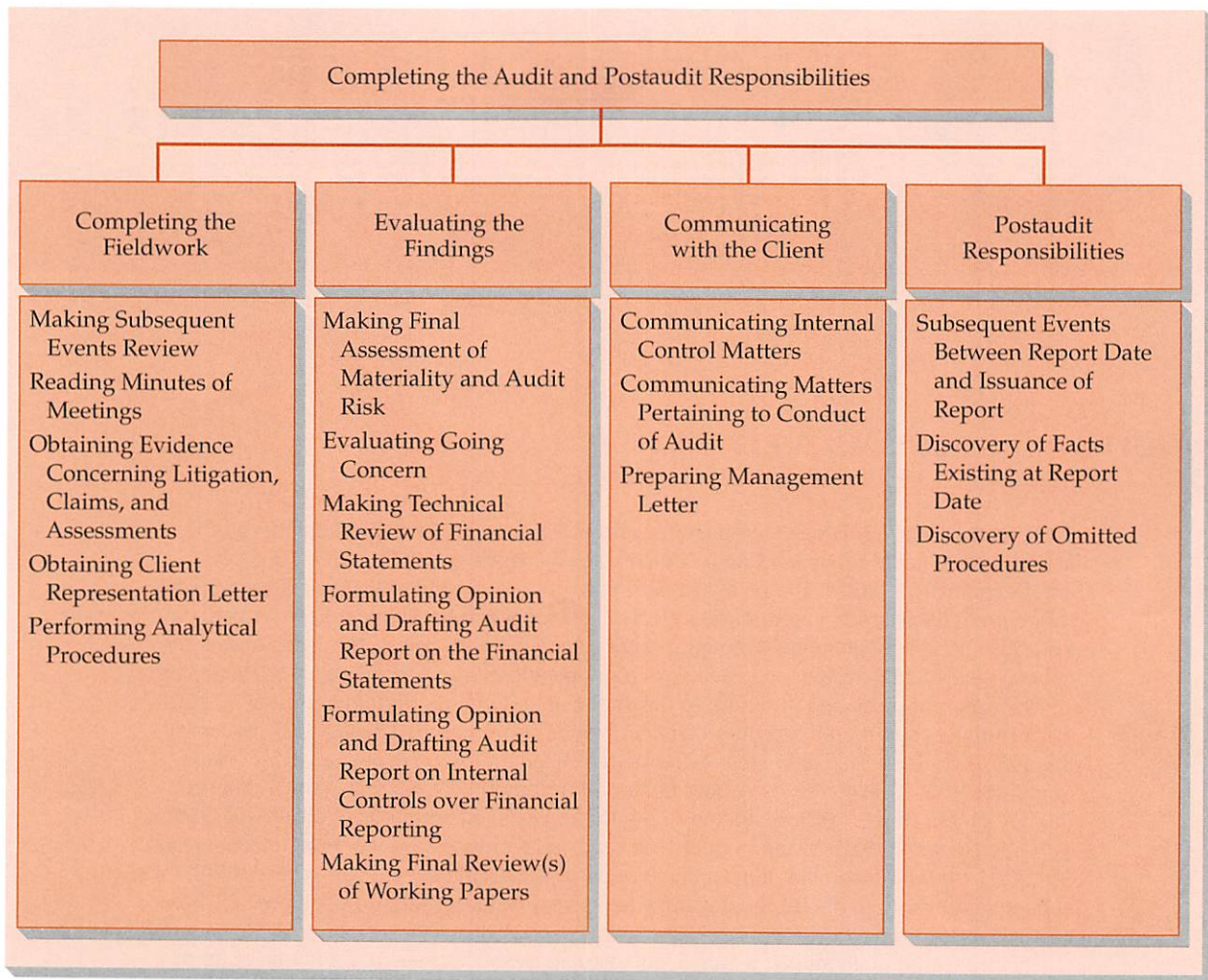
Management disclosed in a note to the financial statements that on February 2, 2002 (approximately one month after the balance sheet date) it had purchased 100 percent of the shares of Bass Holdings, Ltd., in the United Kingdom for approximately \$1.7 billion. Coors added \$2.3 billion to its assets base and accepted over \$600 million in debt for the net assets of \$1.7 billion. Adolph Coors Company financed the \$1.7 billion acquisition with approximately \$1.5 billion in debt. The reported financial statements as of December 30, 2001, show a favorable debt to equity ratio of approximately 0.79:1. After reading the subsequent events footnote, the company looks very different with an additional \$1.5 billion in debt.

This was what auditors call a type 2 subsequent event. The event did not exist as of the balance sheet date and should not affect the December 30, 2001, balance sheet. However, the event occurred prior to the date of the auditor's report, and it is clearly material to the financial statements. As a result, it was rightly disclosed in the notes to the statements.

This event was quite obvious. It would have been announced in the financial press, and it is clearly material to the financial statements. It is appropriate to ask about the auditor's responsibility to search for such events. Does the auditor have to design audit procedures to look for such events? When should such audit procedures be performed? This responsibility and other similar responsibilities are discussed further in this chapter.

[PREVIEW OF CHAPTER 19]

Many aspects of interim and year-end audit testing have been discussed in previous chapters. This chapter is concerned with four important additional areas of activity in a financial statement audit. The following diagram provides an overview of the chapter organization and content.



focus on audit decisions

After studying this chapter you should understand the factors that influence the following audit decisions.

- D1.** What are the auditor's responsibilities with respect to subsequent events?
- D2.** What evidence does an auditor need about litigation, claims, and assessments (LCA)?
- D3.** What is the purpose of a client representation letter, and what should be included in the letter?
- D4.** What is the purpose of performing analytical procedures at the final stages of an engagement?
- D5.** What should be addressed in the process of making a final assessment of materiality and audit risk?
- D6.** What should the auditor consider when evaluating whether an entity is a going concern?
- D7.** What is the purpose of a technical review of the financial statements?
- D8.** What are the key steps involved in forming an opinion and drafting a report on the financial statements?
- D9.** What are the key steps involved in forming an opinion and drafting a report on internal controls over financial reporting?

- D10.** What is the purpose of a final review of working papers?
- D11.** What internal control weaknesses should be reported to management and to the public?
- D12.** What other matters should be communicated to the audit committee associated with a financial statement audit?
- D13.** What is the auditor's responsibility for events that occur between report date and issuing the audit report?
- D14.** What is the auditor's responsibility for events that existed at balance sheet date but were not discovered until after the report was issued?
- D15.** What is the auditor's responsibility for the discovery of omitted procedures after report date?

Procedures performed to complete the audit have the following distinctive characteristics: (1) they do not pertain to specific transaction cycles or accounts, (2) they are performed after the balance sheet date, (3) they involve many subjective judgments by the auditor, and (4) they are usually performed by audit managers or other senior members of the audit team who have extensive audit experience with the client.

This is the last opportunity for the auditor to step above the transaction level and take a holistic look at the financial statements and determine that they represent the underlying business dynamics. The adage, "last but not least," applies to completing the audit. Indeed, the decisions made, and conclusions reached, by the auditor in completing the audit often have a direct impact on the opinion to be expressed on the client's financial statements.

In completing the audit, the auditor frequently works under tight time constraints, particularly as clients seek the earliest possible date for the issuance of the audit report. Although time may not be the auditor's ally, the auditor must take the time to make sound professional judgments and to express the opinion appropriate in the circumstances. For purposes of discussion, the auditor's responsibilities in completing the audit are divided into the following three categories: (1) completing the fieldwork, (2) evaluating the findings, and (3) communicating with the client.

[COMPLETING THE FIELDWORK]

In completing the fieldwork, the auditor performs specific auditing procedures to obtain additional audit evidence. The procedures are:

- Making subsequent events review
- Reading minutes of meetings
- Obtaining evidence concerning litigation, claims, and assessments
- Obtaining client representation letter
- Performing analytical procedures

The procedures do not have to be performed in the foregoing sequence. Each procedure is explained in a following section.

Audit Decision 1

■ What are the auditor's responsibilities with respect to subsequent events?

MAKING SUBSEQUENT EVENTS REVIEW

The auditor's responsibility for assessing the fairness of a client's financial statements is not limited to an examination of events and transactions that occur up to the balance sheet date. AU 560, *Subsequent Events*, states that the auditor also has specified responsibilities for events and transactions that (1) have a material effect on the financial statements and (2) occur after the balance sheet date but prior to the issuance of the financial statements and the auditor's report. These occurrences are referred to as **subsequent events**.

As shown in Figure 19-1, the time frame for a subsequent event extends from the balance sheet date to the issuance of the auditor's report. Figure 19-1 also identifies a **subsequent events period**, which extends from the balance sheet date to the end of fieldwork. During this period, the auditor is required under GAAS to obtain reasonable assurance regarding the discovery of subsequent events. As explained later in the chapter, the auditor has no responsibility to discover subsequent events that occur between the end of fieldwork and the issuance of the audit report.

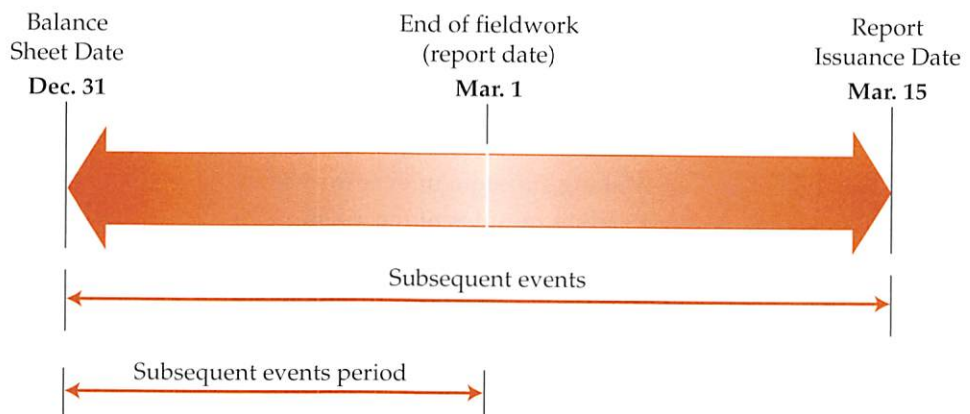
Types of Events

AU 560.03 and 560.05 indicate that there are two types of subsequent events.

- **Type 1 subsequent events** provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements.
- **Type 2 subsequent events** provide evidence with respect to conditions that did not exist at the date of the balance sheet but arose subsequent to that date.

Type 1 events require adjustment of the financial statements. Type 2 events require disclosure in the statements, or in very material cases, attaching pro-forma (as if) data to the financial statements. The following examples are illustrative of the two types of events:

Figure 19-1 ■ Subsequent Events Time Dimensions



TYPE 1	TYPE 2
Realization of recorded year-end assets, such as receivables and inventories, at a different amount than recorded	Issues of long-term bonds or preferred common stock
Settlement of recorded year-end estimated liabilities, such as litigation and product warranties, at a different amount than recorded	Purchase of a business
	Casualty losses resulting from fire or flood

An example may help in distinguishing between the two types of events. Assume that a major customer becomes bankrupt on February 1, 20X1, and that the client considered the customer's balance to be totally collectable in making its estimate of potentially uncollectable accounts in its December 31, 20X0, statements. If, on review of the subsequent event, the auditor determines that the bankruptcy was attributable to the customer's deteriorating financial position that existed (but was unknown to the client) at the balance sheet date, the client should be requested to adjust the December 31, 20X0, statements for the loss. If, on the other hand, the auditor determines that the customer was financially sound at December 31 and the bankruptcy resulted from a fire or similar catastrophe that occurred after the balance sheet date, only disclosure in the notes to the December 31 statements is needed. Ordinarily, type 1 events require adjustment because they typically represent conditions that have accumulated over an extended period of time.

Auditing Procedures in the Subsequent Period

The auditor should identify and evaluate subsequent events up to the date of the auditor's report, which should be as of the end of fieldwork. This responsibility is discharged in the following two ways: (1) by being alert for subsequent events in performing year-end substantive tests such as cutoff tests and searching for unrecorded liabilities and (2) by performing the following auditing procedures specified in AU 560.12 at or near the completion of fieldwork:

- Read the latest available interim financial statements and compare them with the statements being reported on and make other comparisons appropriate in the circumstances.
- Inquire of management having responsibility for financial and accounting matters as to
 - Any substantial contingent liabilities or commitments existing at the balance sheet date or date of inquiry.
 - Any significant changes in capital stock, long-term debt, or working capital to the date of inquiry.
 - The current status of items previously accounted for on the basis of tentative, preliminary, or inconclusive data.
 - Whether any unusual adjustments have been made since the balance sheet date.
- Read minutes of meetings of directors, stockholders, and other appropriate committees.
- Inquire of client's legal counsel concerning litigation, claims, and assessments.

- Obtain letter of representation from client about subsequent events that would, in its opinion, require adjustment or disclosure.
- Make additional inquiries or perform additional procedures considered necessary in the circumstances.

The procedures pertaining to legal counsel and the representation letter are explained later in the chapter.

Effects on Auditor's Report

The failure to record or properly disclose subsequent events in the financial statements will result in a departure from the auditor's standard report. Depending on materiality, the auditor should express either a qualified opinion or an adverse opinion because the financial statements are not presented fairly in conformity with GAAP.

READING MINUTES OF MEETINGS

The minutes of meetings of stockholders, the board of directors, and its subcommittees, such as the finance committee and the audit committee, may contain matters that have audit significance. For example, the board of directors may authorize issue of a new bond, purchase of treasury stock, payment of a cash dividend, or discontinuance of a product line. Each of these circumstances affects management's assertions in the financial statements. The auditor should determine that all minutes of board meetings held during the period under audit and during the period from the balance sheet date to the end of fieldwork have been provided for his or her review. The reading of minutes is ordinarily done as soon as they become available in order to give the auditor the maximum opportunity to assess their significance to the audit. For example, information learned from the minutes might cause the auditor to modify planned substantive tests, or to request the client to include the disclosure of a subsequent event in the financial statements. The auditor's reading of the minutes should be documented in the working papers.

OBTAINING EVIDENCE CONCERNING LITIGATION, CLAIMS, AND ASSESSMENTS

Audit Decision 2

- What evidence does an auditor need about litigation, claims, and assessments (LCA)?

The FASB in SFAS 5, *Accounting for Contingencies*, defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) that will be resolved when one or more future events occur or fail to occur. Gain contingencies, such as a client's claim against others for patent infringement, present only a relatively small problem for the auditor because under GAAP they normally are not recorded until they are realized. Loss contingencies, on the other hand, often represent a significant problem for the auditor. Depending on subjective evaluations of the likelihood of future payment, GAAP requires that loss contingencies either be (1) recorded as contingent liabilities, (2) disclosed in the notes to the financial statements, or (3) ignored. These contingencies include potential liabilities from income tax disputes; product warranties; guarantees of obligations of others; and litigation, claims, and assessments.

The auditor's concerns about contingent liabilities are not limited to completing the audit. During audit testing and particularly in searching for unrecorded liabilities (see Chapter 15), the auditor should be alert for the possibility of contingent liabilities. Moreover, in reading the minutes of board of directors' meetings and in reviewing contracts, the auditor should look for circumstances that may indicate contingencies that should be investigated. GAAS does not specify auditing requirements for all contingencies. However, GAAS does contain requirements for auditing litigation, claims, and assessments. These requirements are usually met at the time of completing the audit because the auditor desires that the evidential matter be obtained as close to the end of fieldwork as is feasible.

Audit Considerations

AU 337.04, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, states that the auditor should obtain evidence on **litigation, claims, and assessments (LCA)**:

1. The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments.
2. The period in which the underlying cause for legal action occurred.
3. The degree of probability of an unfavorable outcome.
4. The amount or range of potential loss.

Because LCAs usually are within the direct knowledge of management, management is the primary source of information about such matters. Accordingly, the auditor should (a) inquire of and discuss with management its means of identifying LCA, (b) obtain from management a description and evaluation of LCA that existed at the balance sheet date, and (c) obtain assurance from management, preferably in writing, of the existence of any unasserted claims. In addition, the auditor should examine documents in the client's possession concerning LCA. The auditor may also obtain information about LCA through reading minutes of board of directors' meetings, contracts and loan agreements, and bank confirmation responses concerning loan guarantees.

Letter of Audit Inquiry

It should be recognized that an auditor normally does not possess sufficient legal skills to make an informed judgment about all LCAs. Thus, AU 337.08 indicates that a **letter of audit inquiry** to the client's lawyer(s) is the auditor's primary means of obtaining corroboration of the information about LCA furnished by management. It should assist the auditor in obtaining evidence about the four items identified in AU 337.04 (see preceding paragraph). Appendix A to AU 337 provides an illustrative audit inquiry letter to legal counsel. Management should send the letter to each lawyer who has been engaged by the client and has given substantive attention during the year to LCA or significant unasserted claims that may be material. The letter should ask the lawyer to respond directly to the auditor.

Effects of Responses on Auditor's Report

The lawyer's responses may have no effect on the auditor's report. That is, the auditor may issue a standard report with an unqualified opinion. This can occur when the responses indicate that, based on a reasonable investigation of the matters at issue, there is (1) a high probability of a favorable outcome or (2) the matters at issue are immaterial.

In some cases, the lawyer's response may indicate significant uncertainty about the likelihood of an unfavorable outcome of LCA or the amount or range of potential loss. For example, the matter may be only in the initial stage of litigation, and there may be no historical experience of the entity in similar litigation. In this situation, the auditor may conclude that the financial statements are affected by an uncertainty that is not susceptible to reasonable estimation at the balance sheet date. If the uncertainty is adequately disclosed in the financial statements, the auditor's report should contain an unqualified opinion.

A lawyer's refusal to respond to a letter of audit inquiry is a limitation on the scope of the audit. Depending on the materiality of the items, the auditor should express a qualified opinion or disclaim an opinion on the financial statements. The auditor may obtain assistance about LCA from the client's legal department. However, because of possible management bias, such help is not a substitute for corroborating information that an outside lawyer refuses to furnish.

OBTAINING CLIENT REPRESENTATION LETTER

Audit Decision 3

■ What is the purpose of a client representation letter, and what should be included in the letter?

The auditor is required to obtain certain written representations from management in meeting the third standard of fieldwork. This is accomplished through a **client representation letter**, commonly referred to as a **rep letter**. AU 333, *Management Representations*, explains that representations are part of evidential matter, but they are not a substitute for the application of the auditing procedures necessary to afford a reasonable basis for an opinion. Management representations:

- Confirm oral representations given to the auditor
- Document the continuing appropriateness of such representations
- Reduce the possibility of misunderstandings concerning management's representations

A rep letter may complement other auditing procedures. For example, a rep letter may complement a letter of audit inquiry of a lawyer by containing management's statements that LCAs are properly accounted for and that there are no unasserted claims or assessments that require disclosure in the financial statements. In some cases, however, a rep letter may be the primary source of audit evidence. For instance, when a client plans to discontinue a line of business, the auditor may not be able to corroborate this event through other auditing procedures. Accordingly, the auditor should request management to indicate its intent in the rep letter.

If a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. For example, management's representations about the classification of held-to-maturity securities may be contradicted by management's sale of such securities. In addition, based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

Content of Representation Letter

AU 333.06 provides guidance on four major categories of specific representations that should be included in a rep letter. The rep letter should include representations about:

- Management's responsibility for the financial statements
- Completeness of information and evidence furnished to the auditor
- Issues regarding revenue recognition, accounting estimates, and disclosures
- Subsequent events

For example, under management's responsibility for the financial statements, management should acknowledge that they are responsible for adjusting the financial statements for material misstatements detected by the auditor, and that any uncorrected misstatements aggregated by the auditor during the current engagement are immaterial, both individually and in aggregate, to the financial statements taken as a whole. Figure 19-2 presents an illustrative rep letter that includes representations related to each of these four major categories. Rep letters should be prepared on the client's stationery, addressed to the auditor, and dated as of the date of the auditor's report. Normally, the chief executive officer and the chief financial officer sign the rep letter. In many audits, the auditor will draft the representations, but management must acknowledge responsibility for these important representations by discussing the items with the auditor and by signing the letter.

Effects on the Auditor's Report

When the auditor obtains a rep letter and he or she is able to corroborate management's representations, a standard audit report can be issued. However, there is a limitation on the scope of the audit when the auditor is unable to (1) obtain a rep letter or (2) support a management representation that is material to the financial statements by other auditing procedures. A scope limitation will result in a departure from the auditor's standard report with either a qualified opinion or a disclaimer of opinion. Management's refusal to furnish written representations may be sufficient, in the auditor's judgment, to cause the auditor to withdraw from the engagement.

PERFORMING ANALYTICAL PROCEDURES

Earlier chapters have explained and illustrated the application of analytical procedures in audit planning and in performing year-end substantive tests. It will be recalled that analytical procedures involve the use of ratios and other comparative techniques. Analytical procedures are also required in completing the audit as an **overall (or final) review** of the financial statements. SAS 56, *Analytical Procedures* (AU 329.22), states that the objective of the overall review is to assist the auditor in assessing conclusions reached in the audit and in evaluating the financial statement presentation taken as a whole.

In making an overall review, the auditor reads the financial statements and accompanying notes and considers the adequacy of the evidence gathered in response to unusual or unexpected balances and relationships (1) anticipated in planning the audit or (2) identified during the audit in substantive testing.

Audit Decision 4

- What is the purpose of performing analytical procedures at the final stages of an engagement?

Figure 19-2 ■ Client Representation Letter

Letterhead of Melville Co., Inc.
Route 32
Midtown, New York 11746

February 14, 20x8
Reddy & Abel, Certified Public Accountants

Dear Sirs:

We are providing this letter in connection with your audit of the balance sheets, income statements, and statement of cash flows. Melville Co., Inc. as of December 31, 20x7 and 20x6 and for the years then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly in all material respects, the financial position, results of operation, and cash flows of Melville Co., Inc. in conformity with Generally Accepted Accounting Principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm to the best of our knowledge and belief, on February 14, 20x8, the following representations made to you during your audit(s).

1. The financial statements referred to above are fairly presented in conformity with Generally Accepted Accounting Standards.
2. We have made available to you all —
 - a. Financial records and related data.
 - b. Minutes of meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. There has been no —
 - a. Fraud involving management or employees who have significant roles in internal control.
 - b. Fraud involving others that could have a material effect on the financial statements.
6. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
7. We believe the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
8. The following have been properly recorded or disclosed in the financial statements.
 - a. Related party transactions, including sales purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
 - b. Guarantees, whether written or oral, under which the company is contingently liable.
 - c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6 *Disclosure of Certain Risks and Uncertainties*.
9. There are no —
 - a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
 - b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5.
 - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
10. The company has satisfactory title to all owned assets, and any liens, encumbrances, or pledges of assets as collateral for loans are adequately disclosed in the notes to the financial statements.
11. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
12. Debt securities that have been classified as held-to-maturity have been so classified due to the company's intent to hold such securities to maturity and the company's ability to do so. All other debt securities appropriately have been classified as available-for-sale or trading.
13. Provision has been made to reduce excess or obsolete inventories to their estimated net realizable value.
14. Capital stock reserved for options, warrants, conversions, or other requirements has been properly disclosed.

To the best of our knowledge and belief, no events have occurred subsequent to the balance sheet date and through the date of this letter that would require adjustments to or disclosure in the aforementioned financial statements.

Mr. Thomas Thorp, President, and CEO

Ms. Marilyn Johnson, CFO

do the financial statements make sense?

An important additional objective of the overall review in one Big Four firm is: Do the financial statements make sense from the point of view of users of the statements? The focus is not on unusual relationships but on whether the impression a user is likely to obtain, based solely on the financial statements, is consistent with the auditor's accumulated knowledge of the entity. In meeting this objective, the firm requires the auditor to consider business ratios and other rules of thumb commonly used in the particular industry because these are the measures that users ordinarily use to evaluate the entity. As in other types of overall reviews, the findings may result in recommendations for changes in presentation and disclosures in the financial statements, additional auditing procedures, or changes in the audit opinion.

Source: KPMG, Peat Marwick, Audit Manual—U.S. (May 1988), pp. II-146-147.

Analytical procedures are then applied to the financial statements to determine whether any additional unusual or unexpected relationships exist. If such relationships exist, additional auditing procedures should be performed in completing the audit.

Analytical procedures in the overall review should be performed by an individual having comprehensive knowledge of the client's business and industry such as a partner or manager on the audit. A variety of analytical procedures may be used. The procedures should be

- Applied to critical audit areas identified during the audit
- Based on the financial statement data after all audit adjustments and reclassifications have been recognized

In making an overall review of the fair presentation in the financial statements, company data may be compared with (1) expected entity results based on the underlying business dynamics, (2) available data on industry performance, and (3) relevant nonfinancial data such as units produced or sold and the number of employees. An overall review would ordinarily compare an entity's reported financial performance with its strategic goals for revenues, customers, and market share, for the efficiency of core processes, and the correspondence of nonfinancial measures with the overall picture reported in the financial statements.

LEARNING CHECK

- 19-1** Identify the three categories of activities that pertain to completing the audit.
- 19-2** List the activities involved in completing fieldwork.
- 19-3**
 - a. Distinguish between the terms *subsequent events* and *subsequent events period*.
 - b. Define the two types of subsequent events and indicate the accounting treatment of each type.
 - c. What is the auditor's responsibility for subsequent events?
- 19-4**
 - a. What evidence is required in an audit of litigation, claims, and assessments?

- b. What is a letter of audit inquiry?
- c. What effects may a lawyer’s failure to respond to a letter of audit inquiry have on the audit report?
- 19-5 a. What objectives are met in obtaining a client representation letter?
- b. What is the impact of a client’s refusal to provide a rep letter?
- 19-6 a. What are the objectives of making an overall review?
- b. Who should make this review?
- c. How should analytical procedures be used in this review?

KEY TERMS

Client representation letter, p. 900	Rep letter, p. 900
Letter of audit inquiry, p. 899	Subsequent events, p. 896
Litigation, claims, and assessments (LCA), p. 899	Subsequent events period, p. 896
Overall (or final) review, p. 901	Type 1 subsequent events, p. 896
	Type 2 subsequent events, p. 896

EVALUATING THE FINDINGS

The auditor has the following two objectives in evaluating the findings: (1) determining the type of opinion to be expressed and (2) determining whether GAAS has been met in the audit. To meet these objectives, the auditor completes the following steps:

- Making final assessment of materiality and audit risk
- Evaluating whether there is substantial doubt about the entity’s ability to continue as a going concern
- Making technical review of financial statements
- Formulating opinion and drafting audit report on financial statements
- Formulating opinion and drafting audit report on internal controls over financial reporting (for public companies)
- Making final review(s) of working papers

These steps are performed in the order in which they are listed.

MAKING FINAL ASSESSMENT OF MATERIALITY AND AUDIT RISK

In formulating an opinion on the financial statements, the auditor should assimilate all the evidence gathered during the audit. An essential prerequisite in deciding on the opinion to express is a final assessment of materiality and audit risk. The starting point in this process is to total the misstatements found in examining all accounts that were not corrected by the client. In some cases, the uncorrected misstatements may have been individually immaterial so that no correction was requested by the auditor. In other cases, the client may have been unwilling to make the corrections that were requested. The next step in the process is to determine the effects of the total misstatements on net income and other financial

Audit Decision 5

■ What should be addressed in the process of making a final assessment of materiality and audit risk?

statement totals to which the misstatements pertain, such as current assets or current liabilities.

The auditor's determination of misstatements in an account should include the following components:

- Uncorrected misstatements specifically identified through substantive tests of details of transactions and balances (referred to as **known misstatement**)
- Projected uncorrected misstatements estimated through audit sampling techniques
- Estimated misstatements detected through analytical procedures and quantified by other auditing procedures

The total of these components for an account is called **likely misstatement**. The sum of the likely misstatement in all accounts is called **aggregate likely misstatement**. The auditor's assessment of aggregate likely misstatement may also include the effect on the current period's financial statements of any uncorrected likely misstatements from a prior period. When including them this may lead to the conclusion that there is an unacceptably high risk that the current period's financial statements are materially misstated. A working paper illustrating one approach to analyzing aggregate likely misstatement is shown in Figure 19-3.

The data that have been accumulated are then compared with the auditor's preliminary judgments concerning materiality that were made in planning the audit. As explained in Chapter 8, planning materiality extends to both the individual account balance and the financial statement levels. If any adjustments in planning materiality have been made during the course of the audit, they should, of course, be included in this assessment.

In planning the audit, the auditor specified an acceptable level of audit risk. As aggregate likely misstatement increases, the risk that the financial statements may be materially misstated also increases. When the auditor concludes that audit risk is at an acceptable level, he or she can proceed to formulate the opinion supported by the findings. However, if the auditor believes that audit risk is not acceptable, he or she should either (1) perform additional substantive tests or (2) convince the client to make the corrections necessary to reduce the risk of material misstatement to an acceptable level.

EVALUATING GOING CONCERN

Audit Decision 6

- What should the auditor consider when evaluating whether an entity is a going concern?

AU 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, establishes a responsibility for the auditor to evaluate whether there is substantial doubt about the client's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (generally one year from the balance sheet date). Ordinarily, information that would raise **substantial doubt** about the going-concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions.

The auditor normally evaluates whether there is substantial doubt about the client's ability to continue as a going concern based on the results of normal audit procedures performed in planning, in gathering evidence to support various audit objectives, and in completing the audit. It may be necessary to obtain

Figure 19-3 ■ Analysis of Aggregate Likely Misstatement Working Paper

		DEBIT				(CREDIT)					
		ASSETS		LIABILITIES							
W/P REF	ACCT. No.	DESCRIPTION ACQUIRED	CURRENT	NON-CURRENT	CURRENT	NON-CURRENT	SHAROLDERS' EQUITY	PRETAX EARNINGS	INCOME TAX EXPENSE		
Uncorrected Known Misstatements											
D-1	1590	Accumulated Depreciation		\$ 3,500							
	4590	Depreciation Expense					\$ (3,500)	\$ (3,500)			
	2295	Income Taxes Payable			\$ (1,225)		\$ 1,225			\$ 1,225	
Overstatement of Depreciation Expense											
Uncorrected Projected Misstatements											
C-1	4200	Cost of Goods Sold					\$ 8,000	\$ 8,000			
	1200	Inventory	\$ (8,000)								
	2295	Income Taxes Payable			\$ 2,800		\$ (2,800)			\$ (2,800)	
Overstatement of Ending Inventory Projected from Statistical Sample											
		Aggregate Likely Misstatement	\$ (8,000)	\$ 3,500	\$ 1,575	\$ —	\$ 2,925	\$ 4,500	\$ (1,575)		
		Final Balance from Trial Balance	\$ 400,000	\$ 735,000	\$ 225,000	\$ 375,000	\$ 535,000	\$ 150,000	\$ 75,000		
		Aggregate Likely Misstatement %	2.0%	0.5%	0.7%	0.0%	0.5%	3.0%	2.1%		

Conclusion: The likely misstatements listed above are deemed to be immaterial, either individually or in their aggregate effects on the individual accounts, the financial statements categories, or the financial statement totals to which they relate.

W/P Ref. A-5
 Date: 2/12/X2
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 Reviewed By: R. E. G.

additional information to support information that mitigates the auditor's doubt.

If the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, he or she should take the following steps. The auditor should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented.

If, after evaluating management's plans, the auditor concludes there is substantial doubt about a going concern, he or she should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the opinion paragraph) in the audit report to reflect his or her conclusion. If the auditor concludes that substantial doubt does not exist, he or she should still consider the need for disclosure. Some of the information that might be disclosed includes:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- The possible effects of such conditions and events
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including relevant prospective financial information)
- Information about (a) the recoverability or classification of recorded asset amounts or, (b) the amounts or classification of liabilities

If, after considering identified conditions and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report is normally an unqualified audit opinion with an explanatory paragraph about the uncertainty (following the opinion paragraph) to reflect that conclusion. The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its [the entity's] ability to continue as a going concern." If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion.

MAKING TECHNICAL REVIEW OF FINANCIAL STATEMENTS

Audit Decision 7

- What is the purpose of a technical review of the financial statements?

Public accounting firms have detailed financial statement checklists that are completed by the auditor who performs the initial review of the financial statements. The purpose of the **financial statement checklist** is to help the auditor evaluate financial statement disclosure assertions. The manager and partner in charge of the engagement then review the completed checklist and the financial statements. Prior to the release of the audit report on a publicly held client, there should also be a technical review of the statements by a partner who was not a member of the audit team.

The checklists include matters pertaining to the form and content of each of the basic financial statements as well as to required disclosures. Most firms now have separate checklists for SEC and non-SEC clients. The completed checklist and the findings of the reviewers should be included in the working papers.

FORMULATING OPINION AND DRAFTING AUDIT REPORT ON THE FINANCIAL STATEMENTS

Audit Decision 8

■ What are the key steps involved in forming an opinion and drafting a report on the financial statements?

During the course of an audit engagement, a variety of audit tests are performed. These tests often are performed by staff personnel whose participation in the audit may be limited to a few areas or accounts. As the tests for each functional area or statement item are completed, the staff auditor is expected to summarize his or her findings.

It is necessary in completing the audit for the separate findings to be summarized and evaluated for the purpose of expressing an opinion on the financial statements taken as a whole. The ultimate responsibility for these steps rests with the partner in charge of the engagement. In some cases, the audit manager makes the initial determinations that are then carefully reviewed by the partner.

Before reaching a final decision on the opinion, a conference generally is held with the client. At this meeting, the auditor reports the findings orally and attempts to provide a rationale for proposed adjustments and/or additional disclosures. Management, in turn, may attempt to defend its position. In the end, some agreement is generally reached on the changes to be made, and the auditor can proceed to issue an unqualified opinion. When such an agreement is not obtained, the auditor may have to issue another type of opinion. Communication of the auditor's opinion is made through an audit report. The various types of auditors' reports were previously discussed in Chapter 2.

FORMULATING OPINION AND DRAFTING AUDIT REPORT ON INTERNAL CONTROLS OVER FINANCIAL REPORTING

Audit Decision 9

■ What are the key steps involved in forming an opinion and drafting a report on internal controls over financial reporting?

Recall from Chapter 2 that public companies must make an assertion about the adequacy of their system of internal control over financial reporting. The auditor of a public company must then form an opinion (1) about the fairness of management's assertion and (2) about the adequacy of internal controls over financial reporting as of balance sheet date. During the course of an audit engagement, staff personnel whose participation in the audit may be limited to a few areas or accounts, perform a variety of tests of controls. It is necessary in completing the audit for the separate findings to be summarized and evaluated for the purpose of expressing an opinion on the system of internal control over financial reporting. If the auditor believes that a material weakness exists (more than a remote chance that a material misstatement, individually or in aggregate, could occur in interim or annual financial statements), the auditor must express an adverse opinion on the effectiveness of the system of internal control over financial reporting. The ultimate responsibility for these steps rests with the partner in charge of the engagement. In some cases, the audit manager makes the initial determinations, which are then carefully reviewed by the partner.

Auditors often perform tests of controls at an early interim date to determine whether material weaknesses exist and to give management time to correct such weakness prior to year-end. Before reaching a final decision on the opinion, a con-

ference generally is held with the client. At this meeting, the auditor reports the findings orally and attempts to provide a rationale regarding internal control weaknesses. However, if the auditor continues to feel that a material weakness exists at the balance sheet date, the auditor must express an adverse opinion on the effectiveness of internal controls over financial reporting. The auditor's opinion is communicated through an audit report on internal controls over financial reporting. The various types of auditors' reports were previously discussed in Chapter 2.

MAKING FINAL REVIEW(S) OF WORKING PAPERS

Audit Decision 10

- What is the purpose of a final review of working papers?

In Chapter 6 the first-level review of working papers by a supervisor was explained. This review is made to evaluate the work done, the evidence obtained, and the conclusions reached by the preparer of the working paper. Additional reviews of the working papers are made at the end of fieldwork by members of the audit team. The levels of review that may be made in completing the audit are shown in the following table:

REVIEWER	NATURE OF REVIEW
Manager	Reviews working papers prepared by seniors and reviews some or all of the working papers reviewed by seniors.
Partner in charge of the engagement	Reviews working papers prepared by managers and reviews other working papers on a selective basis.

The partner's review of the working papers is designed to obtain assurance that

- The work done by subordinates has been accurate and thorough.
- The judgments exercised by subordinates were reasonable and appropriate in the circumstances.
- The audit engagement has been completed in accordance with the conditions and terms specified in the engagement letter.
- All significant accounting, auditing, and reporting questions raised during the audit have been properly resolved.
- The working papers support the auditor's opinion.
- GAAS and the firm's quality control policies and procedures have been met.

Detailed checklists covering the above matters are commonly used in performing the review of working papers.

Some firms require an independent "cold" (or second) review of the working papers by a partner who did not participate in the audit. Such reviews are mandatory in audits of SEC registrants. The rationale for a second partner review is based on the objectivity of the reviewer who may challenge matters approved by earlier reviewers. Thus, the review provides additional assurance that all GAAS have been met in the engagement.

LEARNING CHECK

- 19-7 a. What are the two objectives to be achieved in evaluating the findings?
b. List four steps in meeting these objectives.

- 19-8** a. What are the purposes of the auditor's final assessment of materiality and audit risk?
 b. Distinguish between the terms *known misstatement*, *likely misstatement*, and *aggregate likely misstatement*.
- 19-9** a. Describe the auditor's responsibility to evaluate an entity's ability to continue as a going concern for a reasonable period of time.
 b. What evidence should an auditor use to evaluate a going concern?
 c. If the auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, what should be disclosed in the financial statements?
 d. How does substantial doubt about going concern influence the auditor's opinion on the financial statements?
- 19-10** What is included in the technical review of the financial statements, what aids are used in the review, and who makes the review?
- 19-11** a. How and by whom is the opinion on the financial statements formulated, and how is it communicated?
 b. How are proposed adjustments and disclosures generally resolved?
- 19-12** a. How and by whom is the opinion on the internal controls over financial reporting formulated, and how is it communicated?
 b. Can an auditor resolve material weaknesses in internal control the same way material misstatements in the financial statements are discussed and resolved?
- 19-13** a. Identify the primary reviewers of working papers and the nature of their reviews.
 b. What are the objectives of the engagement partner's review?
 c. Why may a second partner review be desirable?

[KEY TERMS]

Aggregate likely misstatement, p. 905
 "Cold" (or second) review, p. 909
 Financial statement checklist, p. 907

Known misstatement, p. 905
 Likely misstatement, p. 905
 Substantial doubt, p. 905

[COMMUNICATING WITH THE CLIENT]

The auditor's communications with the client at the conclusion of the audit involves the audit committee (or the board of directors) and management. The communications to the audit committee involve matters pertaining to (1) the client's internal controls and (2) the conduct of the audit. The communication to management and the audit committee is normally in the form of a management letter.

Audit Decision 11

■ What internal control weaknesses should be reported to management and to the public?

COMMUNICATING INTERNAL CONTROL MATTERS

During an audit, the auditor may become aware of matters relating to the internal controls over financial reporting that are less than a material weakness that should be of interest to the client's audit committee or to individuals with equivalent authority and responsibility. Both AU 325, *Communication of Internal Control*

Related Matters Noted in an Audit, and PCAOB Standard No. 2, *An Audit of Internal Control over Financial Reporting Conducted in Conjunction with a Financial Statement Audit*, require the auditor to communicate significant deficiencies in internal controls, which are defined as follows:

A **significant deficiency** is an internal control deficiency that adversely affects the company's ability to initiate, record, process, or report external financial data reliably in accordance with GAAP. A significant deficiency could be a single deficiency, or a combination of deficiencies, that results in more than a remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected.

A significant deficiency may pertain to any internal control element. The designation of a significant deficiency is influenced by the likelihood of a misstatement (more than remote) and the magnitude of possible misstatement (more than inconsequential), as explained in Chapter 2.

For private companies, AU 325.04 indicates that the auditor is not required to search for significant deficiencies. He or she may become aware of a significant deficiency by obtaining an understanding of internal controls, performing tests of controls, performing substantive tests, or otherwise during the audit.

The communication preferably should be in writing. The distribution of the report should ordinarily be restricted to the audit committee, management, and others within the organization. However, when such a report is required by governmental authorities, AU 325.11 states that any report issued on significant deficiencies should:

- Indicate that the purpose of the audit is to report on the financial statements and not to provide assurance on the internal controls
- Include the definition of a significant deficiency
- Include the restriction on distributions

AU 325.12 illustrates the sections of a letter on internal control for private companies that includes the following language:

In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 20X1, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. However, we noted certain matters involving the internal control and its operation that we considered to be significant deficiencies under standards established by the American Institute of Certified Public Accountants. A significant deficiency is an internal control deficiency that adversely affects the company's ability to initiate, record, process, or report external financial data reliably in accordance with GAAP. A significant deficiency could be a single deficiency, or a combination of deficiencies, that results in more than a remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected.

(Include paragraphs to describe the reportable conditions noted.)

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

The communication should be made in a timely manner either during the audit or after its conclusion.

The following additional factors may affect the content of the report:

- Because of the potential for misinterpretation of the highly limited degree of assurance provided by the report, the auditor should not state in the report that no significant deficiencies in internal control over financial reporting were noted.
- By agreement with the client, the report may (1) exclude significant deficiencies already known to the audit committee and (2) include matters that do not qualify as significant deficiencies.

Recall that a significant deficiency may be of such magnitude as to be a material weakness, which is defined as follows:

A **material weakness** is a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

If even one material weakness exists in a public company, the auditor is required to issue an adverse opinion on internal controls over financial reporting. In a private company, however, the auditor is not required by GAAS to separately identify and communicate material weaknesses in the report to the audit committee. However, when either by client request or by auditor choice material weaknesses are identified and described in the report, two additional paragraphs are required as part of the auditor's letter. The first paragraph should contain a definition of the term *material weakness* and a description of the deficiencies in internal control that are material weaknesses. As indicated in AU 325.16, the second additional paragraph should describe the limitations of the auditor's work as follows:

Our consideration of internal control would not necessarily disclose all matters in internal control that might be a significant deficiency and, would not necessarily disclose all reportable conditions that are also considered to be material weakness as defined above. However, none of the significant deficiencies described above is believed to be a material weakness.

When the preceding paragraph is included in the report and none of the reportable conditions are considered to be material weaknesses, a statement to this effect is added to the paragraph (see sample above).

Following is an example internal control recommendation.

Cash

Issue

As part of a strong system of internal controls, there should be an appropriate segregation of duties. This ensures that no one employee has access to both physical assets and the related accounting records or to all phases of a transaction.

Finding

Cash receipts are processed by an accounting employee who summarizes the receipts, prepares the deposit slip, and posts the cash to accounts receivable. A cash receipts journal is prepared by the accounting manager who also reconciles the bank accounts.

Recommendation

We suggest that the company establish certain internal control policies with regard to segregation of duties within the area of cash receipts. None of the following duties should be performed by the same person:

- Receive and open mail and run tape of cash receipts.
- Prepare deposit slip from cash receipts.
- Post transactions to accounts receivable, reconciling any differences between tape and deposit slip.
- Reconcile bank accounts.

Audit Decision 12

■ What other matters should be communicated to the audit committee associated with a financial statement audit?

COMMUNICATING MATTERS PERTAINING TO CONDUCT OF AUDIT

AU 380, *Communication with Audit Committees*, requires the auditor to communicate certain matters pertaining to the conduct of the audit to those who have responsibility for overseeing the financial reporting process. Normally, this responsibility is assigned to an audit committee of the board of directors or to a group with equivalent authority such as a finance committee. The communication may be oral or written, and it may occur during or shortly after the audit. When the communication is in writing, the report should indicate that it is intended for the audit committee or the board of directors and, if appropriate, management. AU 380.06-.14 state that the communication with the audit committee may include the following matters:

- *Auditor's responsibility under GAAS* including the assurance provided by an audit that the financial statements are free of material misstatements, concepts of materiality used in the audit, and types of audit tests performed.
- *Significant accounting policies* such as management's initial selection and changes in policies, accounting methods used for significant unusual transactions, and effects of policies in areas that lack authoritative guidance or consensus.
- *Auditor's judgments about the quality of the entity's accounting principles*. The discussion would normally include management as an active participant since it has primary responsibility for establishing accounting principles. An open and frank discussion should include such matters as the consistency of application of accounting policies, the clarity and completeness of the entity's financial statements, and items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements. Examples include (1) the selection of new policies or changes to accounting policies, (2) estimates, judgments, and uncertainties, (3) unusual transactions, and (4) accounting policies related to significant financial statement items, including the timing

of transactions and the period in which they are recorded, or accounting practices that may be unique to an industry.

- *Management judgments and accounting estimates* including the basis for judgments and the process for making accounting estimates.
- *Significant audit adjustments* that individually, or in the aggregate, have an important effect on the entity's financial reporting process.
- *Disagreements with management* that are significant to the financial statements or the auditor's report, and disagreements that pertain to the application of accounting principles and the basis for management's judgments about accounting estimates.
- *Consultation with other accountants* on auditing and accounting matters.
- *Major issues discussed with management prior to retention* including those pertaining to accounting principles and auditing standards.
- *Difficulties encountered in performing the audit* such as unreasonable delays by management in permitting the commencement of the audit and in providing needed information, unavailability of client personnel, and failure of the client to complete client-prepared schedules in a timely manner.

In addition, as explained previously, the auditor must communicate reportable conditions in a company's internal control structure to the audit committee.

PREPARING MANAGEMENT LETTER

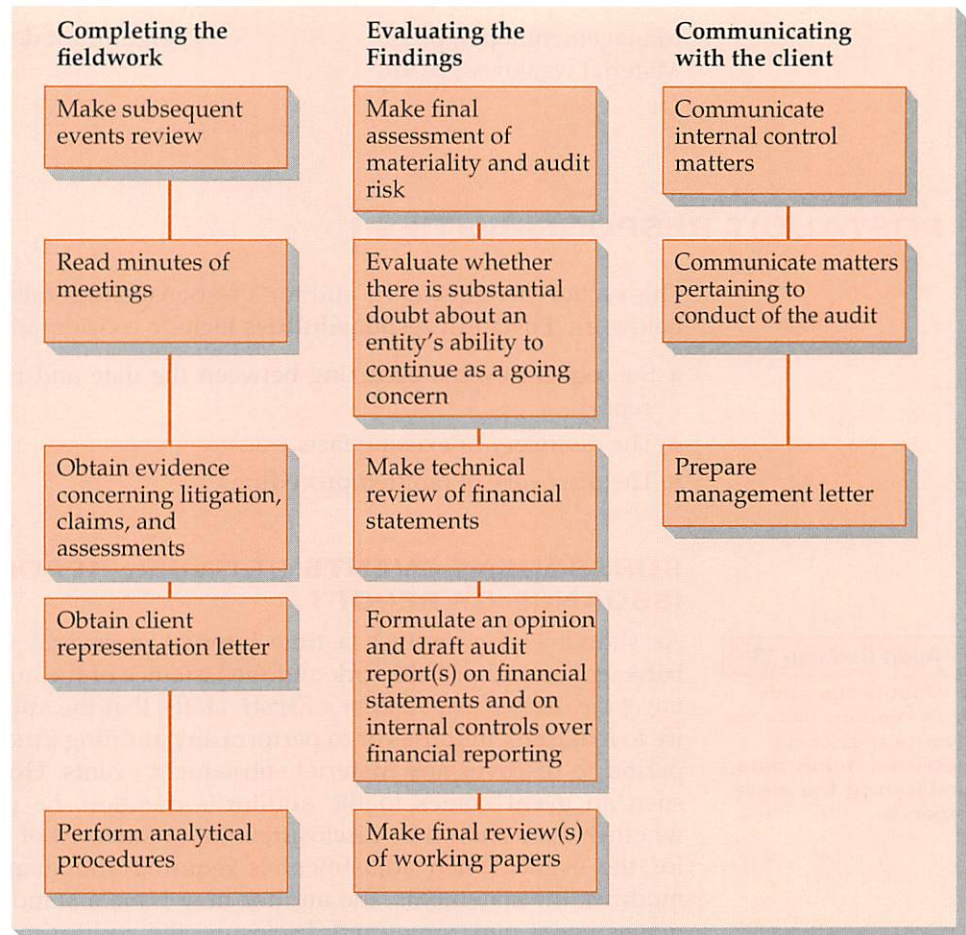
During the course of an audit engagement, auditors observe many facets of the client's business organization and operations. At the conclusion of an audit, many auditors believe it is desirable to write a letter to management, known as a **management letter**, that may include recommendations beyond improvements in the system of internal control. These recommendations usually relate to improving the efficiency and effectiveness of the company's operations. The issuance of such letters has become an integral part of the services rendered by auditors to their clients. A management letter tangibly demonstrates the auditor's continuing interest in the welfare and future of the client. Communicating matters in addition to significant deficiencies in internal control is not required by GAAS.

Matters that are relevant to management letters should be noted in the audit working papers as the audit progresses to ensure that they are not overlooked. Subsequently, the working papers should provide adequate documentation of the management letter comments. Such support will also be useful in any discussions with management about the comments.

Management letters should be carefully prepared, well organized, and written in a constructive tone. Prompt issuance of the letters creates a favorable impression and may encourage both an early and a positive response by management. Management letters may include comments on

- Internal control matters
- Recommendations regarding the management of resources and other services noted during the audit
- Tax-related matters

A summary of the auditor's responsibilities in completing the audit is presented in Figure 19-4.

Figure 19-4 ■ Summary of Auditor's Responsibilities in Completing the Audit

LEARNING CHECK

- 19-14** What parties are involved in the auditor's communications with the client at the conclusion of the audit?
- 19-15** a. Distinguish between reportable conditions and material weaknesses.
b. What are the essential requirements for a report issued on reportable conditions?
- 19-16** What are the effects on a report on reportable conditions when the auditor separately identifies and describes material weaknesses?
- 19-17** a. Indicate the form and timing of the auditor's communication with the audit committee on the conduct of the audit.
b. What matters should be included in the communication?
- 19-18** a. What purpose is served by a management letter?
b. List the types of data that may be included in a management letter.

[**KEY TERMS**]

Management letter, p. 918
 Material weakness, p. 916

Significant deficiency, p. 915

[**POSTAUDIT RESPONSIBILITIES**]

This section pertains to the auditor's responsibilities following the completion of fieldwork. **Postaudit responsibilities** include consideration of

- Subsequent events occurring between the date and issuance of the auditor's report
- The discovery of existing facts
- The discovery of omitted procedures

SUBSEQUENT EVENTS BETWEEN REPORT DATE AND ISSUANCE OF REPORT

Audit Decision 13

■ What is the auditor's responsibility for events that occur between report date and issuing the audit report?

As shown in Figure 19-1, a time interval of several weeks typically elapses between the end of fieldwork and the issuance of the audit report. AU 530, *Dating of the Independent Auditor's Report*, states that the auditor has no responsibility to make any inquiries or to perform any auditing procedures during this time period to discover any material subsequent events. However, if knowledge of such an event comes to the auditor's attention, he or she should consider whether there should be disclosure in or adjustment of the financial statements for the event. When adjustment is required and management appropriately modifies the statements, the auditor may issue a standard audit report. When management makes required disclosure, the auditor may also issue a standard report, providing the report is redated to coincide with the date of the subsequent event.

Alternatively, the auditor may use **dual dating** in the audit report. Under this course of action, the original date is retained except for the dating of the subsequent event. The dual date is indicated in the audit report immediately below the signature of the firm. Assuming the original date of the auditor's report was February 28 and the date of the subsequent event is March 7, the dual dating would appear as follows:

February 28, 20x1, except for the information in Note A for which the date is March 7.

Dual dating is the most common practice because redating of the entire report extends the auditor's overall responsibility beyond the completion of fieldwork. Under redating, the auditor should extend the subsequent events review procedures to the later date.