DISCOVERY OF FACTS EXISTING AT REPORT DATE

Audit Decision 14

■ What is the auditor's responsibility for events that existed at balance sheet date but were not discovered until after the report was issued?

The auditor has no responsibility for the postaudit discovery of facts existing (but unknown) at the date of the audit report. However, AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* indicates that if (1) the auditor becomes aware of such facts and (2) the facts may have affected the report that was issued, the auditor is required to ascertain the reliability of the information. When the investigation confirms the existence of the fact and the auditor believes the information is important to those relying or likely to rely on the financial statements, the auditor should take steps to prevent future reliance on the audit report.

The preferred result is the preparation of revised statements by the client and the issuance of a revised audit report as soon as practicable. If the client refuses to disclose the newly discovered facts, the auditor should notify each member of the board of directors of such refusal. In addition, AU 561.08 states that the auditor should take the following steps to prevent further reliance on the report:

- Notify the client that the audit report must no longer be associated with the financial statements.
- Notify the regulatory agencies having jurisdiction over the client that the report should no longer be relied on.
- Notify (generally via the regulatory agency) each individual known to be relying on the statements that the report should no longer be relied on.

AU 561.09 provides guidelines for the auditor in notifying parties other than the client. When the auditor has been able to make a satisfactory investigation and has determined that the information is reliable, he or she should describe the effects the subsequently acquired information would have had on the financial statements and the auditor's report. When the client has not cooperated and the auditor has been unable to make a satisfactory investigation, without disclosing the specific information, the auditor should (1) indicate the lack of cooperation and (2) state that if the information is true, the audit report should no longer be relied on.

DISCOVERY OF OMITTED PROCEDURES

Audit Decision 15

■ What is the auditor's responsibility for the discovery of omitted procedures after report date?

After the date of the audit report, the auditor may conclude that one or more auditing procedures considered necessary in the circumstances was omitted from the audit. Auditing standards do not require the auditor to conduct any postaudit reviews of his or her work. However, discovery of an omitted procedure may result from a postengagement review performed during a firm's quality control inspection program or during an outside peer review.

On discovery of an omitted procedure, the auditor should assess its importance to his or her ability to currently support the opinion expressed on the financial statements. A review of the working papers and a reevaluation of the overall scope of the audit may enable the auditor to conclude that he or she can still support the previously expressed opinion. Alternatively, AU 390.05, *Consideration of Omitted Procedures after the Report Date,* indicates that if the auditor decides that the opinion cannot be supported and he or she believes persons are currently relying on the report, the auditor should promptly perform the omitted procedures or alternative procedures that would provide a satisfactory basis for the opinion.

When a satisfactory basis for an opinion is obtained and the evidence supports the opinion expressed, the auditor has no further responsibility. However, if the performance of the omitted procedures reveals facts existing at the report date that would have changed the previously expressed opinion, the auditor should follow the notification procedures described in the last paragraph of the preceding section to prevent further reliance on the report. If the auditor is unable to perform the omitted or alternative procedures, he or she should consult an attorney to determine an appropriate course of action.

LEARNING CHECK

19-19 a. Explain the auditor's responsibility for discovery of subsequent events occurring after completion of fieldwork but before issuance of the audit report.
b. When such an event occurs and is appropriately reflected in the financial statements, what are the auditor's alternatives with respect to dating the audit report and the conditions applicable to each alternative?

19-20 a. What responsibility does the auditor have for the postaudit discovery of facts existing at the date of the auditor's report?
b. Identify the steps the auditor should take when the client refuses to make disclosure of the newly discovered facts.

19-21 What information should the auditor include in a notification of parties other than the client about the postaudit discovery of facts when he or she has been (a) able and (b) unable to make a satisfactory investigation of the facts?

19-22 a. What responsibility does the auditor have upon discovery of omitted procedures after the report date?
b. Indicate the possible consequences of the auditor's investigation of omitted procedures.

KEY TERMS

Dual dating, p. 916

Postaudit responsibilities, p. 916

FOCUS ON AUDIT DECISIONS

This chapter focuses on (1) procedures performed in completing fieldwork, (2) evaluating audit findings, (3) communicating with the client, and (4) postaudit responsibilities. Figure 19-5 summarizes the audit decisions discussed in Chapter 19 and provides page references indicating where these decisions are discussed in more detail.

Figure 19-5 ■ Summary of Audit Decisions Discussed in Chapter 19

Audit Decision	Factors that Influence the Audit Decision	Chapter References
Completing Fieldwork		
D1. What are the auditor's responsibilities with respect to subsequent events?	Figure 19-1 graphically depicts the subsequent events period. Type 1 subsequent events provide additional evidence about conditions that existed at balance sheet date and affect the estimates inherent in the financial reporting process. They require adjustment of the financial statements. Type 2 subsequent events provide evidence about conditions that did not exist at balance sheet date but arose subsequent to that date. Type 2 subsequent events require disclosure. Important audit procedures should include: ■ Read the latest interim financial statements after year-end. ■ Inquire of management about (a) any substantial contingent liabilities or commitments, (b) any significant changes in capital stock, long-term debt, or working capital, (c) the current status of items previously accounted for on the basis of tentative data, (d) whether any unusual adjustments have been made since 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.	pp. 896–898
D2. What does an auditor need evidence about with respect to litigation, claims, and assessments (LCA)?	With respect LCA, the auditor should obtain evidence about (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; and (4) the amount or range of potential loss. Evidence is obtained both from management and the client's lawyer(s).	pp. 898–900
D3. What is the purpose of a client representation letter and what should be included in the letter?	A client rep letter documents a number of important understandings with the client, including (1) management's responsibility for the financial statements, (2) the completeness of information and evidence furnished to the auditor, (3) issues regarding revenue recognition, accounting estimates, and disclosures, and (4) issues about subsequent events. Figure 19-2 provides an example rep letter.	pp. 900–901

(continues)

Figure 19-5 ■ (Continued)

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D4. What is the purpose of performing analytical procedures at the final stages of an engagement?	The auditor performs analytical procedures to evaluate the reasonableness of other decisions reached at the conclusion of the engagement. The auditor performs a test to make sure the financial statements are consistent with his or her knowledge of the business dynamics, and other information obtained during the audit.	pp. 901–903
Evaluating Findings		
D5. What should be addressed in the process of making a final assessment of materiality and audit risk?	At the end of the engagement, the auditor needs to aggregate audit findings to determine if audit evidence indicates the existence of material misstatements. The auditor should consider both known misstatements and projected or likely misstatements. Figure 19-3 provides an example of how auditors might aggregate audit findings. The auditor assesses risk at the assertion level. At the end of the audit, the auditor needs to review the risk assessments and evidence obtained to ensure that audit risk is reduced to a sufficiently low level.	pp. 904–905
D6. What should the auditor consider when evaluating whether an entity is a going concern?	The auditor needs to assess whether there is *substantial doubt* about an entity's ability to continue as a going concern in every audit. The chapter provides examples of the types of situations that represent substantial doubt and explains the process of evaluating going concern.	pp. 905–907
D7. What is the purpose of a technical review of the financial statements?	A technical review is usually performed by a manager or partner to determine compliance with GAAP. Auditors normally use detailed financial statement checklists to guide the evaluations of the completeness and accuracy of financial statement disclosures.	pp. 907–908
D8. What are the key steps involved in forming an opinion and drafting a report on the financial statements?	Ultimately, the engagement partner must evaluate the audit evidence obtained and make a decision about the opinion that should be rendered on the financial statements. If misstatements aggregate to a material amount, the auditor will normally meet with the client, present the audit findings and rationale, and allow the client to adjust the financial statements and receive an unqualified opinion. The various types of opinions were explained in Chapter 2.	p. 908
D9. What are the key steps involved in forming an opinion and drafting a report on internal controls over financial reporting?	When considering an opinion on internal control (for a public company), the auditor must evaluate deficiencies in internal control in terms of the probability that a deficiency will allow a misstatement to occur and the magnitude of the potential misstatement. The auditor will normally test controls and identify any material weaknesses in internal control at an interim date to give the client an opportunity to improve internal controls. If a material weakness exists at balance sheet date, the auditor will have to issue an adverse report on the effectiveness of internal controls over financial reporting. The various types of opinions were explained in Chapter 2.	pp. 908–909

(continues)

Figure 19-5 ■ (Continued)

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D10. What is the purpose of a final review of working papers?	The final review of working papers is performed to obtain assurance that (1) the work done by subordinates has been accurate and thorough, (2) the judgments exercised by subordinates were appropriate in the circumstances, (3) the audit engagement has been completed in accordance with the conditions specified in the engagement letter, (4) all significant accounting, auditing, and reporting questions raised during the audit have been properly resolved, (5) the working papers support the auditor's opinion, and (6) GAAS and the firm's quality control policies and procedures have been met.	p. 909
Communicating with the Client		
D11. What internal control weaknesses should be reported to management and to the public?	In an audit of internal controls for a public company, material weaknesses are communicated in an auditor's report on internal controls, and significant deficiencies must be communicated to the audit committee. In a private company audit, both material weaknesses and significant deficiencies should be reported to the audit committee, or its equivalent.	pp. 910–913
D12. What other matters should be communicated to the audit committee associated with a financial statement audit?	Other required communications with the audit committee, or its equivalent, include (1) the auditor's responsibility under GAAS, (2) significant accounting policies, (3) the auditor 's judgments about the quality of the entity's accounting principles, (4) management judgments and accounting estimates, (5) significant audit adjustments, (6) disagreements with management, (7) consultation with other accounts, and (8) difficulties encountered in performing the audit.	pp. 913–915
Postaudit Responsibilities		
D13. What is the auditor's responsibility for events that occur between report date and issuing the audit report?	The auditor is not required to search for subsequent events that happen after report date. If the auditor finds important type 2 events after report date, they are normally disclosed in the financial statements, and report date for the subsequent event note is different from report date on the financial statements (dual dating).	p. 916
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?	The auditor has no responsibility to search for subsequent events after report date. If (1) the auditor becomes aware of such facts and (2) the facts may have affected the report that was issued, the auditor is required to ascertain the reliability of the information. When the investigation confirms the existence of the fact and the auditor believes the information is important to those relying or likely to rely on the financial statements, the auditor should take steps to prevent further reliance on the audit report.	p. 917
D15: What is the auditor's responsibility for the discovery of omitted procedures after report date?	If peer review or other quality control inspection programs determine that important procedures were omitted from an audit, the auditor should promptly perform the omitted procedures. If the evidence obtained supports the opinion expressed, the auditor has no other responsibilities. If the evidence causes the auditor to change his or her opinion, the auditor should take steps to prevent further reliance on the audit report.	pp. 917–918

objective questions

Objective questions are available for the student at www.wiley.com/college/boynton

comprehensive questions

19-23 **(Subsequent events)** Green, CPA, is auditing the financial statements of Taylor Corporation for the year ended December 31, 20X1. Green plans to complete the fieldwork and sign the auditor's report about May 10, 20X2. Green is concerned about events and transactions occurring after December 31, 20X1, that may affect the 20X1 financial statements.

Required

a. What are the general types of subsequent events that require Green's consideration and evaluation?

b. What are the auditing procedures Green should consider performing to gather evidence concerning subsequent events?

19-24 **(Subsequent events/client representation letter/management letter)** Charles Jones is the controller of Precision Tool & Die Corporation, a closely held firm. The principal owners of the company are seeking to retire soon and to sell their share interests. As audited financial statements will be needed during the process, the firm of Higgins & Clark has been hired to audit the financial statements for the fiscal year ended November 30, 20X8.

At a recent meeting with the owners, Jones presented a status report on the audit. Most of the fieldwork has been completed, and the preliminary financial statements will be prepared within the next 10 days. Higgins & Clark has targeted a report issue date of January 15, 20X9. In response to a query regarding work remaining to be done, Jones identified the following three major tasks that must be accomplished:

- A subsequent events review
- The client representation letter
- The management letter

Required

a. 1. Describe the purpose of a subsequent events review.
   2. Describe the two actions that might be taken upon discovery of a material subsequent event and the potential effect of each action on the firm's financial statements.

b. 1. Describe the purpose of the client representation letter.
   2. Identify four items that may appear in a client representation letter.

c. 1. Define the purpose served by the management letter.
   2. Identify three major subjects that may be addressed in the management letter.

ICMA

19-25 **(Subsequent events)** In connection with the audit of Flowmeter, Inc., for the year ended December 31, 20X0, Hirsch, CPA, is aware that certain events and transactions that took place after December 31, 20X0, but before Hirsch issues his report dated February 8, 20X1, may affect the company's financial statements.

The following material events or transactions have come to his attention.

1. On January 3, 20X1, Flowmeter, Inc., received a shipment of raw materials from Canada. The materials had been ordered in October 20X0 and shipped FOB shipping point in November 20X0.

2. On January 15, 20X1, the company settled and paid a personal injury claim of a former employee as the result of an accident that occurred in March 20X0. The company had not previously recorded a liability for the claim.
3. On January 25, 20X1, the company agreed to purchase for cash the outstanding stock of Porter Electrical Company. The acquisition is likely to double the sales volume of Flowmeter, Inc.
4. On February 1, 20X1, a plant owned by Flowmeter, Inc., was damaged by a flood, resulting in an uninsured loss of inventory.
5. On February 5, 20X1, Flowmeter, Inc., issued and sold to the general public $2 million in convertible bonds.

Required

For each of the above events or transactions, indicate the audit procedures that should have brought the item to the attention of the auditor and the form of disclosure in the financial statements including the reasons for such disclosure. Organize your answers in the following format:

Item No.	Audit Procedures	Required Disclosures and Reasons

AICPA

19-26 **(Litigation, claims, and assessments)** Young, CPA, is considering the procedures to be applied concerning a client's loss contingencies relating to litigation, claims, and assessments.

Required

What substantive audit procedures should Young apply when testing for loss contingencies relating to litigation, claims, and assessments?

AICPA

19-27 **(Litigation, claims, and assessments)** During an audit engagement, an auditor is expected to communicate with lawyers concerning litigation, claims, and assessments. Listed below are five situations regarding LCA. The last clause or sentence of each case states a conclusion.

1. If the client's lawyer is silent on certain aspects of an attorney's letter request, the auditor may infer the response is complete.
2. Letters of audit inquiry ask for the lawyer's evaluation of the probable outcome of matters reported in the response. If the lawyer's response does not contain this evaluation, the auditor should conclude the scope of the audit has been restricted.
3. The Top Dollar Corporation is involved in litigation for which the potential liability is so great that an unfavorable judgment at or near the claimed amount would seriously impair its operations. This is how the company's attorneys answered the legal confirmation request: "Although no assurance can be given as to the outcome of this action, based on the facts known by us to date, in the confidence of the attorney/client relationship and otherwise, and our understanding of the present law, we believe the company has good and meritorious defense to the claims asserted against it and should prevail." On this basis, the independent auditor may issue an unqualified opinion.

4. In situations where the auditor has orally discussed matters involving litigation with the client's legal counsel and obtained his oral opinion on the outcome of disputed matters, it is not necessary to obtain written confirmation of these oral opinions if the auditor has summarized the attorney's opinion in a memo to the working papers.
5. For the past 10 years, XYZ Company has used the services of JJH&I for its primary legal advice and in many significant matters of litigation. Ninety-five percent of JJH&I's legal fees originate from services performed for XYZ Company. At December 31, JJH&I was handling litigation involving great potential liability to the company and has now responded to the auditor's letter of inquiry. If we assume full disclosure, complete reliance can be placed on this response.

Required

For each case, indicate whether you agree or disagree with the conclusion and the reason(s) therefor.

19-28 **(Client representation letter)** During the audit of the annual financial statements of Amis Manufacturing, Inc., the company's president, R. Alderman, and Luddy, the auditor, reviewed matters that were supposed to be included in a written representation letter. On receipt of the following client representation letter, Luddy contacted Alderman to state that it was incomplete:

To E. K. Luddy, CPA

In connection with your audit of the balance sheet of Amis Manufacturing, Inc., as of December 31, 20X5, and the related statements of income, retained earnings, and changes in cash flows for the year then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly the financial position, results of operations, and changes in cash flows of Amis Manufacturing, Inc., in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your audit. There were no

- Plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
- Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
- Agreements to repurchase assets previously sold.
- 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.
- Unasserted claims or assessments that our lawyer has advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.
- Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.
- Compensating balance or other arrangements involving restrictions on cash balances.

R. Alderman, President

Amis Manufacturing, Inc.

March 14, 20X6

Required

Identify the other matters that Alderman's representation letter should specifically confirm.

AICPA

19-29 **(Analytical procedures in overall review)** In auditing the financial statements of a manufacturing company that were prepared from data processed by electronic data processing equipment, the CPA has found that his traditional "audit trail" has been obscured. As a result, the CPA may place increased emphasis on overall checks of the data under audit.

These overall checks, which are also applied in auditing visibly posted accounting records, include the computation of ratios, which are compared with prior-year ratios or industry-wide norms. Examples of such overall checks or ratios are the computation of the rate of inventory turnover and the computation of the number of days' sales in receivables.

Required

a. Discuss the advantages to the CPA of the use of ratios as overall checks in an audit.

b. In addition to the computations given above, list the ratios that a CPA may compute during an audit as overall checks on balance sheet accounts and related nominal accounts. For each ratio listed, name the two (or more) accounts used in its computation.

c. When a CPA discovers that there has been a significant change in a ratio when compared with the prior year's ratio, he considers the possible reasons for the change. Give the possible reasons for the following significant changes in ratios:
   1. The rate of inventory turnover (ratio of cost of sales and average inventory) has decreased from the prior year's rate.
   2. The number of days' sales in receivables (ratio of average daily accounts receivable and sales) has increased over the prior year.

AICPA

19-30 **(Significant deficiency/material weaknesses)** On completing the work on the internal control of the Klima Corporation in the 20X4 audit, an inexperienced staff member was asked to prepare the communication for the audit committee. The audit team concluded that there were several reportable conditions but no material weaknesses. The first and last paragraphs of the staff member's draft were as follows:

> To the Audit Committee:
>
> In completing our audit of the financial statements of the Klima Corporation for the year ended December 31, 20X4, we considered its internal control environment in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to express an opinion on internal controls. However, we noted certain matters involving the design and effectiveness of the system of internal control that we consider to be reportable conditions under GAAS established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to potential weaknesses in the design or operation of internal control that, in our judgment, could adversely affect the organization's ability to prepare financial statements in conformity with GAAP.
>
> ...
>
> This report is intended solely for the audit committee and others within the organization.

Required

a. List the deficiencies in the report. For each deficiency, indicate the proper wording. Use the following format for your answers: (*Note:* Do not write a proper report.)

DEFICIENCY	PROPER WORDING

b. Distinguish between a reportable condition and a material weakness.

c. Indicate the effects on the report when the auditor wishes to inform the audit committee that identified reportable conditions are not material weaknesses.

19-31 **(Management letter)** The major result of a financial audit conducted by an independent accountant is the expression of an opinion by the auditor on the fairness of the financial statements. Although the auditor's report containing the opinion is the best known report issued by the independent auditor, other reports are often prepared during the course of a normal audit. One such report is the management letter (informal report).

Required

a. What is the purpose of a management letter?

b. Identify the major types of information that are likely to be covered in a management letter. Support your answer with a detailed example of one of the types identified above.

ICMA

19-32 **(Subsequent events/postaudit discovery of facts)** The fiscal year of the Edie Company ends on December 31. Your audit report, dated February 26, is to be delivered to the client on March 9. Listed below are events that occur or are discovered from the date of the balance sheet to June 30 of the following year. Assume each event has a material effect on the financial statements.

1. Jan 15 Inventory is sold at a price below December 31 net realizable value.
2. Jan 20 A major customer becomes bankrupt from ongoing net losses.
3. Jan 31 The board of directors authorizes the acquisition of a company as a subsidiary.
4. Feb 10 A fire destroys a major company warehouse.
5. Feb 25 A lawsuit is decided against the company for an accident that occurred on October 10. The damages are three times higher than estimated on December 31.
6. Feb 28 The board of directors authorizes a two-for-one stock split.
7. Mar 7 A foreign government expropriates a major foreign subsidiary following the unexpected overthrow of the government.
8. Mar 31 A court rules that a minority group is the rightful legal owner of land on which an operating division is located.

Required

a. Identify each event as a (1) type 1 subsequent event during the subsequent events period, (2) type 2 subsequent event during the subsequent events period, (3) type 1 subsequent event occurring after fieldwork but before issuance of report, (4) type 2 subsequent event occurring after fieldwork but before issuance of report, or (5) postaudit discovery of facts existing at date of report.

b. Explain your audit responsibilities for each category in (a).

c. Indicate how you would obtain knowledge of each of the eight items.

d. What additional responsibilities does an auditor have for the postaudit discovery of facts if the client refuses to make required disclosures?

cases

19-33 **(Mt. Hood Furniture, Inc., completing the audit)** Complete the following requirements based on the following information on Mt. Hood Furniture. Fieldwork was completed on February 28, 20X4.

Required

a. Evaluate the fair presentation of the following two subsequent events.
   1. On January 20, 20X4, Dealer No. 55 filed for bankruptcy protection based on the fact that it was having financial difficulties.
   2. Robert Saws owns the land under the manufacturing and sales facilities of Mt. Hood Furniture. On January 15, 20X4, Saws agreed to sell the land back to Mt. Hood Furniture for $2.0 million. Appraisals of the land ranged from $1.8 million to $2.25 million. Mt. Hood will pay $250,000 down and annual installments of $250,000 plus interest at 8 percent.

b. Based on your findings in other aspects of this case, prepare an analysis of aggregate likely misstatements similar to that shown in Figure 19-3.

c. Draft a representation letter for discussion with the CEO, Conrad Saws, and the CFO, Julia Anderson.

d. Draft a letter communicating internal control related matters to Mt. Hood Furniture, Inc. based on your review of internal controls in prior chapters.

e. Evaluate whether you have substantial doubt about the ability of Mt. Hood Furniture, Inc. to continue as a going concern for a reasonable period of time. Summarize your conclusions in a memo to the working papers. Discussions with Conrad Saws, James Doyle, and Julia Anderson disclose the following information. Your professor will provide you with projected financial statements that Julia Anderson has prepared based on the following assumptions.
   - Sales growth is planned at 10 percent per year for the next few years to improve operating cash flows.
   - The company believed it could maintain a 28 percent gross profit margin and achieve the expected sales growth.
   - Fixed assets acquisition would average about $500,000 per year, and depreciation would increase approximately $50,000 per year.
   - Selling expenses would average approximately 12 percent of sales revenues.
   - General and administrative expenses were relatively fixed but could grow at approximately 6 percent per year.
   - Other operating expenses were relatively fixed but could grow at approximately 4 percent per year.
   - The effective tax rate for combined federal and state income taxes was estimated at 40 percent. The deferred portion of income tax expenses was expected to be approximately 5 percent of total tax expenses.

   Company targets for the operating cycle were as follows.

	20X4	20X5
Account Receivable Turn Days	69	66
Inventory Turn Days	90	90
Accounts Payable Turn Days	55	50

   - Prepaid expenses, accrued payroll, and accrued expenses were expected to grow at approximately 4 percent per year.
   - The company would have to maintain the following ratios with respect to debt covenants.
     - Current ratio: 1.75:1
     - Quick ratio: 0.9:1
     - Debt to net worth: 2.0:1
     - Dividends to net income: 0.25:1

19-34 **(Letter of audit inquiry)** Cole & Cole, CPAs, are auditing the financial statements of Consolidated Industries Co. for the year ended December 31, 20X2. On April 2, 20X3, an inquiry letter to J. J. Young, Consolidated's outside attorney, was drafted to corroborate the information furnished to Cole by management concerning pending and threatened litigation, claims, and assessments, and unasserted claims and assessments. On May 6, 20X3, C. R. Brown, Consolidated's chief financial officer, gave Cole a draft of the inquiry letter below for Cole's review before mailing it to Young.

May 6, 20X3

J. J. Young, Attorney at Law

123 Main Street

Anytown, USA

Dear J. J. Young:

In connection with an audit of our financial statements at December 31, 20X2, and for the year then ended, management of the Company has prepared, and furnished to our auditors, Cole & Cole, CPAs, 456 Broadway, Anytown, USA, a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. Your response should include matters that existed at December 31, 20X2. Because of the confidentiality of all these matters, your response may be limited.

In November 20X2, an action was brought against the Company by an outside salesman alleging breach of contract for sales commissions and pleading a second cause of action for an accounting with respect to claims for fees and commissions. The causes of action claim damages of $300,000, but the Company believes it has meritorious defenses to the claims. The possible exposure of the Company to a successful judgment on behalf of the plaintiff is slight.

In July 20X0, an action was brought against the Company by Industrial Manufacturing Co. (Industrial) alleging patent infringement and seeking damages of $20,000,000. The action in U.S. District Court resulted in a decision on October 16, 20X2, holding that the Company infringed seven Industrial patents and awarded damages of $14,000,000. The Company vigorously denies these allegations and has filed an appeal with the U.S. Court of Appeals for the Federal Circuit. The appeal process is expected to take approximately two years, but there is some chance that Industrial may ultimately prevail.

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which of your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete. Your response may be quoted or referred to in the financial statements without further correspondence with you.

You also consulted on various other matters considered pending or threatened litigation. However, you may not comment on these matters because publicizing them may alert potential plaintiffs to the strengths of their cases. In addition, various other matters probable of assertion that have some chance of an unfavorable outcome, as of December 31, 20X2, are unasserted claims and assessments.

C. R. Brown

Chief Financial Officer

Required

Describe the omissions, ambiguities, and inappropriate statements and terminology in Brown's letter.

AICPA

professional simulations

Situation	Events Subsequent to Balance Sheet Date	Research	Going Concern

Jose Rojas is an audit partner in a large southwestern office of a national accounting firm. He is completing the audit of Southwest Medical Laboratories (SML), a pharmaceutical company that has several manufacturing locations in North America. You are the in-charge accountant on the SML engagement and are faced with the following issues that need to be resolved before you can complete your report on the financial statements.

Situation	Events Subsequent to Balance Sheet Date	Research	Going Concern

Following is a list of events that occurred subsequent to SML's year-end, June 30, 20X1. You have completed fieldwork on August 21, 20X1 and anticipate issuing your audit report on August 30, 20X1. Identify the type of event that each event represents using the following coding:

a. A type I subsequent event
b. A type II subsequent event
c. A subsequent event occurring after the completion of fieldwork but before issuance of report
d. A subsequent discovery of facts existing at the date of the auditor's report
e. A subsequent discovery of omitted audit procedures after the report date

	a.	b.	c.	d.	e.
1. On August 25, 20X1 you read in the morning paper that the Board of Directors of SML has decided to lay off 100 workers at one of its manufacturing locations due to reduced sales of the product manufactured at the facility. On August, 20X1 all the remaining workers went on strike.	○	○	○	○	○
2. The SML engagement is selected for peer review in October of 20X1. The peer reviewer disagrees with your professional judgment not to send a confirmation on a major account payable to the construction company building a new manufacturing facility in Mexico. In response to the comment you contact the construction company and learn that material invoices were not recorded, understating construction-in-progress and accounts payable.	○	○	○	○	○
3. On August 21, 20X1 the company signed an agreement to purchase 100 percent of the assets and research and development of Unicorn Research Inc. for $7 million. SML issued new common stock to the shareholders of Unicorn amounting to $3 million and added new debt from available lines of credit in the amount of $4 million.	○	○	○	○	○

4. On August 15, 20X1 SML paid a $200,000 personal injury claim of an employee as a result of an accident that occurred in May of 20X1. The claim was covered in the letter regarding litigation, claims and assessments from the client's lawyer who indicated that is was probable that the company would settle the claim. SML had not previously recorded a liability for the claim.

5. On September 22, 20X1 SML had to make good on a guarantee of a third parties investment in United Medical Labs (UML), and unconsolidated subsidiary. SML's CFO determines that as of the end of the first quarter SML should consolidate UML in its financial statements. Your firm had previously read contracts regarding this investment and had not received any evidence of the guarantee. Inquiries of management about contingent liabilities also did not surface the guarantee. Had you known about the guarantee you believe that UML should be consolidated in SML's financial statements as of June 30, 20X1.

6. On June 29, 20X1 SML reached an agreement with to sell certain patents to Houston Research for $1 million. Papers were signed on June 29, 20X1 and final documents were received from the lawyers on July 6, 20X1. The sale was recorded on July 8, 20X1 after documents were received from the lawyers.

7. On August 3, 20X1 SML was denied U.S. Food and Drug Administration approval for a cancer drug that it has been working on for the past five years. The application was submitted on the U.S. Food and Drug Administration on January 15, 20X1. The company had built an inventory of $1 million of the cancer drug as of June 30, 20x1.

Situation	Events Subsequent to Balance Sheet Date	Research	Going Concern

Following is list events that occurred subsequent to SML's year-end, June 30, 20X1. In the space provided in the table below indicate the appropriate U.S. auditing standards paragraph(s), AU reference, which explains the auditor's responsibility to plan procedures to find each event.

AU Reference

1. On August 25, 20X1 you read in the morning paper that the Board of Directors of SML has decided to lay off 100 workers at one of its manufacturing locations due to reduced sales of the product manufactured at the facility. On August 27, 20X1 all the remaining workers went on strike.
2. The SML engagement is selected for peer review in October of 20X1. The peer reviewer disagrees with your professional judg-

AU Reference

ment not to send a confirmation on a major account payable to the construction company building a new manufacturing facility in Mexico. In response to the comment you contact the construction company and learn that material invoices were not recorded, understating construction-in-progress and accounts payable. ____________

3. On August 21, 20X1 the company signed an agreement to purchase 100 percent of the assets and research and development of Unicorn Research Inc. for $7 million. SML issued new common stock to the shareholders of Unicorn amounting to $3 million and added new debt from available lines of credit in the amount of $4 million. ____________
4. On August 15, 20X1 SML paid a $200,000 personal injury claim of an employee as a result of an accident that occurred in May of 20X1. The claim was covered in the letter regarding litigation, claims, and assessments from the client's lawyer who indicated that is was probable that the company would settle the claim. SML had not previously recorded a liability for the claim. ____________
5. On September 22, 20X1 SML had to make good on a guarantee of a third party's investment in United Medical Labs (UML), and unconsolidated subsidiary. SML's CFO determines that as of the end of the first quarter SML should consolidate UML in its financial statements. Your firm had previously read contracts regarding this investment and had not received any evidence of the guarantee. Inquiries of management about contingent liabilities also did not surface the guarantee. Had you known about the guarantee you believe that UML should be consolidated in SML's financial statements as of June 30, 20X1. ____________
6. On June 29, 20X1 SML reached an agreement to sell certain patents to Houston Research for $1 million. Papers were signed on June 29, 20X1 and final documents were received from the lawyers on July 6, 20X1. The sale was recorded on July 8, 20X1 after documents were received from the lawyers. ____________
7. On August 3, 20X1 SML was denied U.S. Food and Drug Administration approval for a cancer drug that it has been working on for the past five years. The application was submitted on the U.S. Food and Drug Administration on January 15, 20X1. The company had built an inventory of $1 million of the cancer drug as of June 30, 20x1. ____________

Situation	Events Subsequent to Balance Sheet Date	Research	Going Concern

Following is a brief summary of SML's financial condition, results of operations, and cash flows for the year ended June 30, 20X1.

Southwest Medical Laboratories

Summary Financial Information

General Ledger Information as of June 30, 20x1

Current Assets	$ 6,000,000	Revenue	$ 7,000,000
Long-term Assets	$ 4,000,000	Net Loss	$<3,500,000>
Total Assets	$ 10,000,000		
		Cash Flow from Operations	$<2,500,000>
Current Liabilties	$ 5,500,000		
Long-term Liabiltiies	$ 3,500,000		
Total Liabilities	$ 9,000,000	Available Lines of Credit	$ 4,500,000
Contributed Capital	$ 9,000,000		
Retained Earnings	$ (8,000,000)		
Total Equity	$ 1,000,000		
Total Liabilities and Equity			

SML expected that the approval of its new cancer drug would increase operating cash flow by $3.5 million dollars a year. In addition, the acquisition of Unicorn research should increase operating cash flow by approximately $700,000 a year. They also received $1 million from the sale of patent on July 8, 20X1.

Prepare a memo to the audit file evaluating SML's ability to continue as a going concern as of report date.

To: Audit File

Re: SML Going Concern Evaluation

From: CPA Candidate

20 Attest and Assurance Services, and Related Reports

A BUSY DAY WITH LOTS OF QUESTIONS

Keith Lewis was an assurance partner in a large local CPA firm in his community. On the way home, the reflected on what he thought had been one of the most unique days in his career.

It began with a question from an audit client that had significant debt covenants with the local bank. The client wanted to impress the bank and had come in to ask if Keith could audit the company's compliance with debt covenants as well as the financial statements. Keith responded that he thought he could only give negative assurance on the compliance with debt covenants, in addition to positive assurance on the financial statements, but he would get back to the client the following day.

A second client called an hour later with another unusual request. This client was about to sign a rental agreement. The rent was based on gross sales, and called for an annual audit of sales from that particular location. Keith's firm audited the financial statements that included sales from 12 stores. Could it perform an audit of only sales for only the one store? Keith responded that it would have to be a separate engagement, but that his firm could perform the audit.

Over lunch with a prospective client. Keith learned that the entity kept its records on a cash basis of accounting. The bank wanted an audit, and was willing to accept cash basis financial statements. The client was concerned that cash basis statements were not GAAP and did not want to set up another set of books. Could Keith's firm audit the cash basis financial statements without giving a qualified or an adverse opinion? Keith responded that cash basis statements were another comprehensive basis of accounting and that he could issue an unqualified opinion on cash basis financial statements. Keith said that his firm had just completed a similar engagement for a company that used the federal income tax basis of accounting.

After lunch, Keith had a meeting with another audit client. The client was considering a business expansion and wanted Keith's firm to advise the client on the business risks involved. He felt that Keith's firm had asked questions about business risk when performing the audit, and wondered what other services the firm could perform. Keith briefly explained a service called CPA Risk Advisory and said that he would put together a proposal for the client.

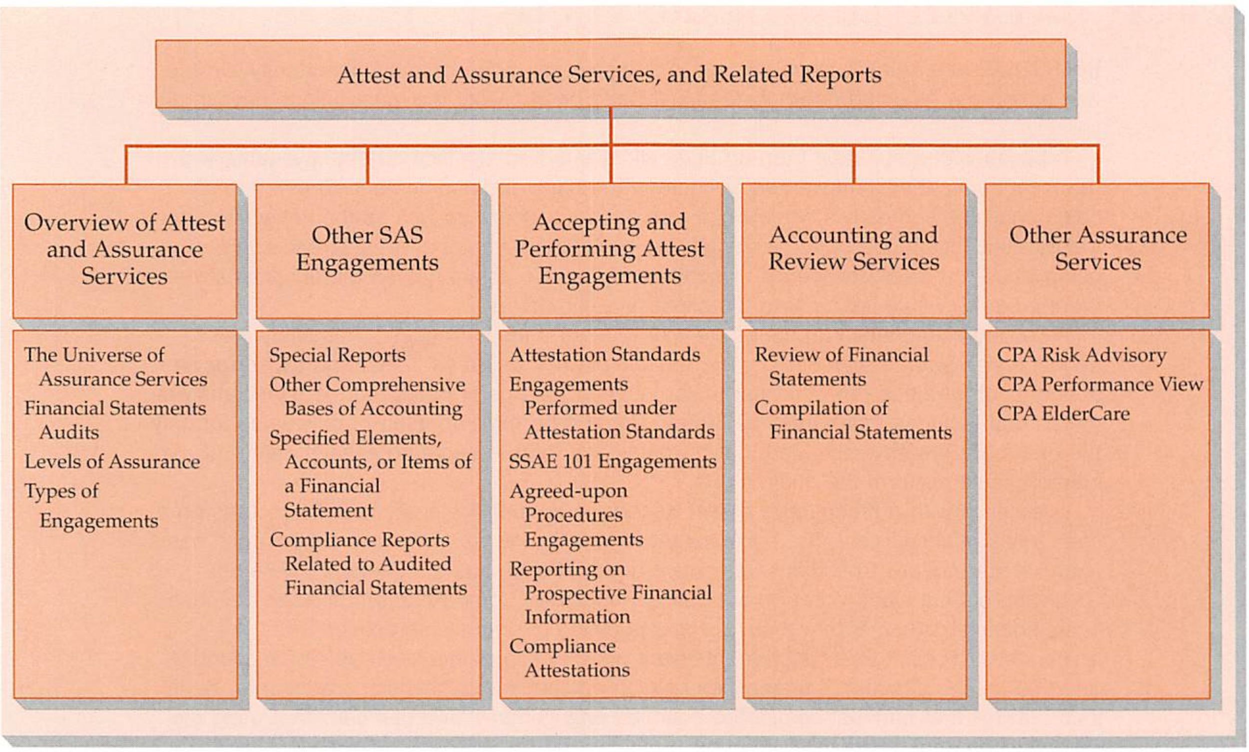
In addition to reviewing regular audit working papers, Keith had had four requests for assurance services that were not for traditional audits. Keith reflected back on the fact that the profession had changed and grown substantially from his first days in the profession. What requests would he receive tomorrow?

Over the years, CPAs have earned a reputation for independence, integrity, and objectivity. This reputation has created opportunities for a wide array of assurance services.

Chapter 20 describes many of these nontraditional attest and assurance services offered by CPAs.

[PREVIEW OF CHAPTER 20]

Chapters 1 through 20 focus on the process of auditing financial statements that are prepared in accordance with GAAP. The financial statement audit is the cornerstone of a variety of services offered by CPAs, as well as the reason for the regulatory franchise associated with granting CPA licenses. Based largely on the skills, experience, and reputation that CPAs have acquired as auditors, businesses, regulatory agencies, and others have increasingly turned to the public accounting profession for a widening range of other types of attest and nonattest services.These are explained in more detail in this chapter. 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 address the following audit decisions:

D1. What opinions can be used in an audit of the basic financial statements?

D2. What are the primary options in terms of level of service that might be available for an attest engagement?

D3. What are the professional standards that cover most audit and attest engagements?

D4. Under what circumstances can an auditor audit and report on financial statements prepared in accordance with an other comprehensive basis of accounting?

D5. Under what circumstances can an auditor audit and report on an individual element, account, or item of the financial statements?

D6. Under what circumstances can an auditor audit and report on compliance with contractual agreements?

D7. What are the attestation standards, and how do they compare with GAAS?

D8. What are the basic principles for a WebTrust engagement?

D9. What are the basic principles and criteria for a SysTrust engagement?

D10. What conditions must be met in order to accept an agreed-upon procedures engagement?

D11. What is the difference between a financial forecast and a projection, and what levels of assurance can be provided on prospective financial statements?

D12. What assurance can be provided in a compliance attestation performed in accordance with SSAEs?

D13. What procedures should be performed to support a review and a compilation of the financial statements?

D14. What language should be used for a review and a compilation report?

D15. What are the types of services that might be performed as part of a CPA Risk Advisory engagement?

D16. What are the types of services that might be performed as part of a CPA Performance View engagement?

D17. What are the types of services that might be performed as part of a CPA ElderCare engagement?

[OVERVIEW OF ATTEST AND ASSURANCE SERVICES]

UNIVERSE OF ASSURANCE SERVICES

Recall from Chapter 1 that CPAs perform a wide range of assurance services. **Assurance services** are independent professional services that improve the quality of information, or its context, for decision makers. The universe of assurance services is depicted in Figure 20-1, and it includes audits, attest services, compilation and review services, and other assurance services.

The audit is the most valued and respected service offered by CPAs. The financial statement audit is the primary subject matter of this book. Other attest services have been offered and accepted in the marketplace. An audit of internal controls over financial reporting began as an attest service. Today, CPAs perform other attest services such as attesting to a financial projection or forecast, or performing an agreed-upon procedures engagement. This chapter explores the full universe of assurance services. It explains the various assurance services, the level of assurance that each service provides, and the types of report that may be issued by CPAs.

FINANCIAL STATEMENT AUDITS

Audit Decision 1

■ What opinions can be used in an audit of the basic financial statements?

The financial statement audit has been the cornerstone of the accounting profession. In most states the CPA license gives CPAs a monopoly to audit financial statements. By performing financial statement audits, CPAs have developed a reputation for independence, integrity, and objectivity. Chapter 2 discussed auditor responsibilities and auditor reports. Appendix 2A provides a number of examples of audit reports, along with a narrative that explains the meaning of each report and the auditor's criteria for using a report. Figure 20-2 summarizes some of the key examples contained in Chapter 2.

Figure 20-1 ■ Universe of Assurance Services

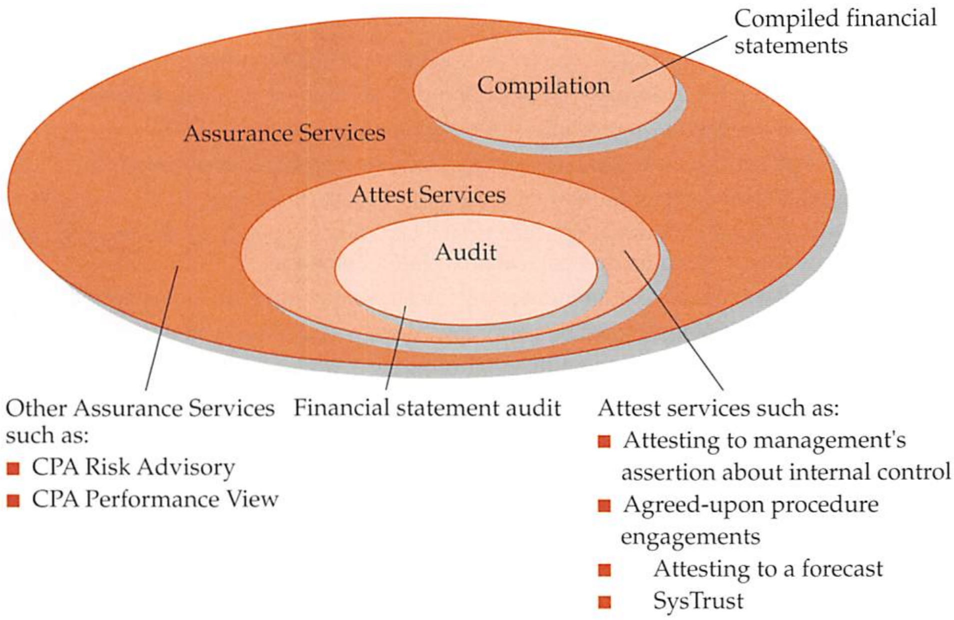


Figure 20-2 ■ A Summary of Examples of Common Audit Reports

Report	Example
Standard report on audited financial statements	Figure 2-3, page 65
Departures from the standard report on audited financial statements	Figure 2-4, page 71
Unqualified opinion on the financial statements with explanatory language regarding going concern	Appendix 2A, page 85
Unqualified opinion on the financial statements with explanatory language regarding a change in accounting principles accounted for in conformity with GAAP	Appendix 2A, page 86
Unqualified opinion on the financial statements with opinion based in part on report of another auditor where there is no scope limitation or nonconformity with GAAP	Appendix 2A, page 87
Unqualified opinion on the financial statements with emphasis of a matter by the auditor	Appendix 2A, page 88
Qualified opinion for departure from GAAP	Appendix 2A, page 89
Qualified opinion for scope limitation	Appendix 2A, page 90
Adverse opinion for departure from GAAP	Appendix 2A, page 91
Disclaimer of opinion for scope limitation	Appendix 2A, page 92
Unqualified opinion—other comprehensive basis of accounting	Appendix 2A, page 93
Standard audit report on internal controls over financial reporting	Figures 2-5, page 73

LEVELS OF ASSURANCE

Audit Decision 2

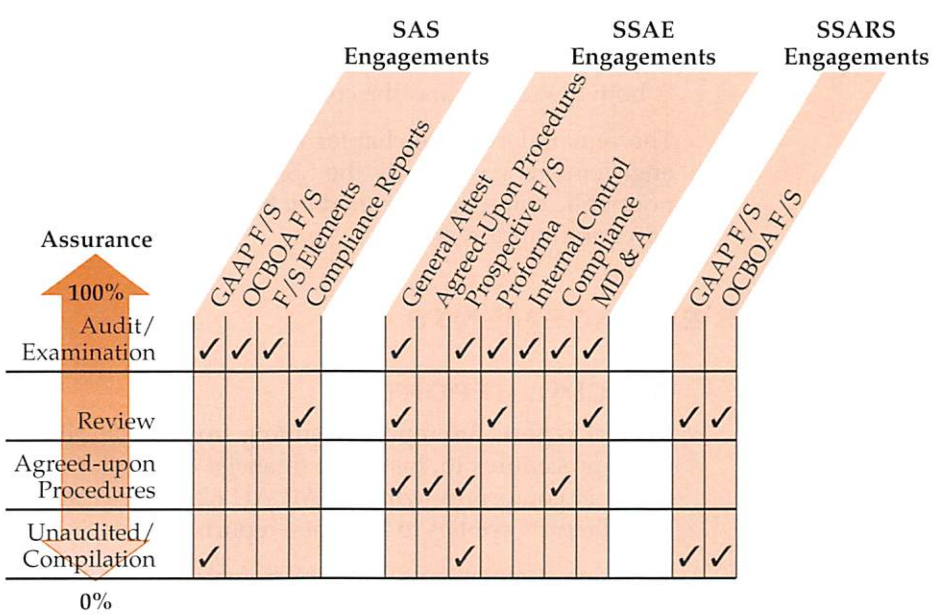
■ What are the primary options in terms of level of service that might be available for an attest engagement?

The CPA profession has developed a number of services that build upon the financial statement audit. Some of these services provide audit level assurance on other assertions. Some of these services provide less than audit-level assurance on financial statements. Figure 20-3 depicts an Assurance/Service Matrix that shows how the CPAs reputation for independence, integrity, and objectivity has resulted in expanding the levels of assurance and the types of engagements offered by CPAs. The core service discussed in this book, the audit of GAAP financial statements, is depicted in the upper-left corner of the Assurance/Service Matrix. The following discussion provides an overview of the four basic levels of assurance offered by CPAs and the types of engagements on which these levels of assurance might be rendered.

The four basic levels of assurance can be described as follows:

- **Audit or examination-level assurance,** where the intent of the engagement is a positive expression of an opinion by the CPA regarding an assertion by management governed by professional standards.
- **Review-level assurance,** where the intent of the engagement is for the CPA to express **negative assurance** that nothing came to his or her attention that led the CPA to believe that the assertion by management governed by professional standards would be misleading.
- **Agreed-upon procedures,** where the intent of the engagement is for the CPA to provide a summary of findings based on agreed-upon procedures applied to an assertion by management governed by professional standards. The level of assurance may vary depending on the procedures applied to the assertion.
- **No assurance,** where the intent of the engagement is to assist management in the preparation of information included in an assertion governed by professional standards. Chapter 1 refers to these services as **accounting and compilation**

Figure 20-3 ■ Assurance/Service Matrix



services. The CPA will explicitly state that no assurance is provided in his or her report associated with management's assertion.

Each of these levels of assurance will be discussed in detail throughout this chapter.

TYPES OF ENGAGEMENTS

Audit Decision 3

■ What are the professional standards that cover most audit and attest engagements?

All the types of engagements discussed in this chapter are covered by professional standards developed by the AICPA and are summarized in Figure 20-3. These professional standards promote uniformity in quality of practice and enhance users' understanding of the differences in the types of services rendered and the levels of assurance associated with them. CPAs who perform many of these types of services must also subject their practices to regular peer review. The basic professional standards issued by the Auditing Standards Board that relate to these services are as follows:

- **Statements on Auditing Standards (SAS).** The SASs are interpretations of generally accepted auditing standards and generally relate to management's assertions about elements contained in the financial statements. The types of engagements discussed in this chapter include reporting on financial statements prepared on a comprehensive basis of accounting other than GAAP, reporting on specified elements, accounts, or items of a financial statement, and compliance reports related to audited financial statements.
- **Statements on Standards for Attestation Engagements (SSAE).** The SSAEs establish a broad framework for a variety of attest services increasingly demanded of the accounting profession. The standards and related interpretive commentary are designed to provide professional guidelines that will enhance both consistency and quality in the performance of such services. This chapter provides an overview of attestation standards and discusses reporting on many of the services covered by attestation standards.
- **Statements on Standards for Accounting and Review Services (SSARS).** The SSARSs define the services associated with the review or the compilation of financial statements of a nonpublic entity and provide guidance to accountants concerning the standards and procedures applicable to these two engagements. These services are available only to nonpublic entities; this chapter will discuss both the review and the compilation service.

The remainder of the chapter discusses special reports covered by SASs, attest engagements covered by the SSAEs, and financial statements engagements for nonpublic companies covered by the SSARSs. It concludes with a brief section on other assurance services.

OTHER SAS ENGAGEMENTS

SPECIAL REPORTS

Special reports are reports resulting from the audit of, or application of agreed-upon procedures to, historical financial data other than financial statements prepared in conformity with GAAP. AU 623, *Special Reports,* indicates that the term *special reports* applies to auditors' reports on

- Financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles

- Specified elements, accounts, or items of a financial statement
- Compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements
- Financial presentations to comply with contractual agreements or regulatory provisions
- Financial information presented in prescribed forms or schedules that require a prescribed form of auditors' report

Special reports based on an audit are similar to the auditor's standard report in that they usually contain an introductory paragraph, a scope paragraph, and an opinion paragraph. However, as explained and illustrated below, special reports have wording that differs from the language in the auditor's standard report. In addition, the "standard" special report may have four or even five paragraphs depending on the circumstances. The explanation of special reports in this chapter is limited to the first three items in the foregoing list.

OTHER COMPREHENSIVE BASES OF ACCOUNTING

Audit Decision 4

- **Under what circumstances can an auditor audit and report on financial statements prepared in accordance with an other comprehensive basis of accounting?**

Four comprehensive bases of accounting other than GAAP are recognized in AU 623.04:

- A basis used to comply with the requirements or financial reporting provisions of a governmental regulatory agency
- A basis used to file the entity's income tax return
- The cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support
- A basis that uses a definite set of criteria that has substantial support such as the price-level basis of accounting

The use of an **other comprehensive basis of accounting (OCBOA)** is common. Many companies subject to regulatory bodies keep their accounts solely on the basis prescribed by the agency. For example, railroads conform with the requirements of the Interstate Commerce Commission (ICC), public utilities use the basis set forth by the Federal Energy Regulatory Commission, and insurance companies follow state insurance commission accounting requirements. In addition, many small companies and individual practitioners, such as doctors, lawyers, and CPAs, use the income tax, cash, or modified cash basis of accounting. When an entity uses a basis other than GAAP, the notes to the financial statements should indicate the basis of accounting.

All of the 10 GAAS are applicable whenever the auditor audits and reports on any financial statement, regardless of the basis of accounting used in preparing the statement. The major difference in this case is that the statements are not intended to present fairly financial position, and so forth, in conformity with GAAP. However, the first standard of reporting is satisfied by indicating whether the statements are presented fairly in conformity with the basis of accounting used.

The auditor's special report on financial statements prepared on an OCBOA should contain four paragraphs:

- An *introductory paragraph* that is the same as in the auditor's standard report except that more distinctive titles should be used for the financial statements, such as statement of assets and liabilities arising from cash transactions.

- A *scope paragraph* that is the same as in the auditor's standard report.
- An *explanatory paragraph* following the scope paragraph that states the basis of presentation and refers to the note to the financial statements that describes the comprehensive basis of accounting other than GAAP.
- An *opinion paragraph* that expresses the auditor's opinion (or disclaims an opinion) on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described.

As in the case of financial statements prepared in conformity with GAAP, the auditor's special report on statements prepared on an OCBOA may contain additional explanatory language when (1) the auditor cannot express an unqualified opinion or (2) circumstances require explanatory language with an unqualified opinion. An example of a special report on financial statements prepared on a cash basis of accounting is illustrated in Figure 20-4. Notice that distinctive language is used in describing the financial statements in the introductory paragraph and in the wording of the opinion paragraph.

Audit Decision 5

Under what circumstances can an auditor audit and report on an individual element, account, or item of the financial statements?

SPECIFIED ELEMENTS, ACCOUNTS, OR ITEMS OF A FINANCIAL STATEMENT

An auditor is not limited to auditing entire financial statements. A CPA can audit an element of the financial statements, an account, or an item in the financial statements. These engagements may include audits of rentals, royalties, profit participation plans, or the provision for income taxes. A special report may be issued on

Figure 20-4 ■ Special Report—Cash Basis of Accounting

Independent Auditor's Report

We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

As described in note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in note X.

Source: AU 623.08.

these data as a result of an audit to obtain reasonable assurance about their fair presentation.

An audit culminates in the expression of an opinion on the fairness of the presentation of the specified elements, accounts, or items. The specified data may be presented in conformity with GAAP or an OCBOA, or on the basis of an agreement such as a lease contract. All 10 GAAS are applicable when the specified data are presented in conformity with GAAP or an OCBOA. Otherwise, the first reporting standard is inapplicable. An engagement to express an opinion on specified elements, accounts, or items may be made in conjunction with the audit of the financial statements or in a separate engagement.

Distinctive wording is required in the introductory, scope, and opinion paragraphs of the special report because the auditor is not reporting on the financial statements taken as a whole. A special report on a royalty contract is illustrated in Figure 20-5. In describing the basis of presentation (paragraph 3), if considered necessary, the auditor may include any significant interpretations of the contract made by the company's management. In expressing an opinion, AU 623.13 indicates that the auditor should recognize that the concept of materiality must be related to each individual element, account, or item being reported on rather than

Figure 20-5 ■ Special Report on Royalties: Separate Audit Engagement; Audited Data Presented per Agreement

Independent Auditor's Report

We have audited the accompanying schedule of royalties applicable to engine production of the Q division of XYZ Corporation for the year ended December 31, 20X2, under the terms of a license agreement dated May 14, 20XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation's interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to the customer.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q division of XYZ Corporation during the year ended December 31, 20X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

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

Source: AU 623.18.