



# Audit Workpapers:

## Documenting and Reviewing Field Work

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# **AUDIT WORKPAPERS: DOCUMENTING AND REVIEWING FIELD WORK**

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**BY DON PALLAIS, CPA**

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## Solutions 1

### Solutions 1

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## Chapter 1

# Definition of Working Papers

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### Learning objective

After completing this chapter, you should be able to do the following:

- Identify the working paper requirements in AU-C section 230 and other applicable guidance.
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### Introduction

This course is designed to instruct staff auditors in the proper preparation of audit documentation. CPAs generally refer to audit documentation as working papers (or workpapers), so that is the terminology used here. This course discusses

- the professional standards regarding working paper documentation and
- proper working paper technique.

This course is based on AU-C section 230, *Audit Documentation*, which requires auditors on every engagement to prepare and maintain audit documentation. In this chapter, we examine that requirement and learn about specific working papers that are required by other professional standards. We also look at the impact of practice-monitoring programs and the litigation climate on documenting the work performed.

# Why working papers are important

The end product of an audit is the relatively brief auditor's opinion. This and the accompanying financial statements are what is seen by the company's management, creditors, and investors. Most people never see the large volume of working papers, but this does not mean working papers are unimportant. On the contrary, they are the foundation for the audit opinion, and they assist auditors during and after the audit.

After the audit procedures are complete, the working papers are the audit. They represent the only documented record of what was done and what the auditor found. The only way the auditor can reconstruct what was done is either through memory or by referring to the working papers, and the passage of time or later circumstances will likely question the reliability of the auditor's memory.

In addition, working papers are the primary communication vehicle among auditors. Working papers prepared by staff are reviewed by more senior members of the audit team to ensure that the work was done properly and all relevant factors were considered in forming an opinion on the financial statements being audited. Faulty working papers could result in faulty communications among the audit team and lead the CPA firm to issue the wrong opinion on the financial statements.

Generally accepted auditing standards (GAAS) pose some specific requirements for working papers that should be met if the work is to be done in accordance with GAAS. Requirements established by other bodies may also include specific working paper requirements that should be adhered to in specific situations.

Thus, the proper preparation of working papers is critical to the performance of the audit.

It is often the case that in lawsuits accountants are criticized or penalized not because their work was deficient but because their working papers did not reflect the work done. That is, they did the work or considered the appropriate matters but could not prove it because the working papers provided inadequate documentation. These accountants paid the price even though they applied the procedures that were appropriate in the circumstances.

If the working papers do not reflect what was done, a court may have no basis to conclude that the appropriate procedures were performed. Failure to adequately document what was done may be assessed essentially as *failure to perform* appropriate procedures. In fact, historically, peer reviewers have taken the position of "not documented, not done." Working paper documentation is very important.

Working papers are crucial after the audit because they

- Provide information about whether the audit was conducted as planned and whether the financial statements are presented in conformity with generally accepted accounting principles;
- Demonstrate evidence of conformity with auditing standards for supervisory review, practice monitoring programs (for example, peer reviews), and for litigation, if necessary; and
- Leave a roadmap for future audits.



# Basic working paper requirements

Generally accepted auditing standards (GAAS) impose many specific documentation requirements based on the notion that documentation is an essential element of audit quality. The trend in standards has been towards more specific documentation requirements as the Auditing Standards Board came to believe that the need to document an item will drive practice to better incorporate required procedures and considerations into audits.

Although auditing standards establish specific working paper requirements, decisions about the quantity, type, and content of working papers is generally a matter of auditor judgment. That is, standards require that certain things be documented, but how you document them is up to you, based on your preferences and your firm's policies.

In this section, we examine the fundamental requirements imposed by AU-C section 230. Then, we review specific guidelines required by other auditing standards. To do your job well as an auditor, it is essential that you understand the details in your professional standards and the reasons for them. Begin by reading AU-C section 230 reproduced in appendix for Chapter 1, taking special note of the functions and nature of working papers, their contents, and ownership.

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## Audit standards affecting working paper content

### AU-C Section 230

AU-C section 230, *Audit Documentation*, requires the auditor to prepare and maintain working papers. It says that the form and content of working papers should be designed to meet the circumstances of the particular audit engagement, but working papers should be sufficient to provide a clear understanding of the following:

- Nature, timing, and extent of auditing procedures applied;
- Results of the auditing procedures;
- Evidence obtained and its source;
- Significant findings or issues arising during the audit;
- Conclusions reached; and
- Significant professional judgments made in reaching those conclusions; and
- Indicate who performed and reviewed the work and when the work was performed and reviewed.

The documentation should be sufficiently detailed that an experienced auditor with no previous connection to the audit can understand the scope and results of the work, the conclusions reached, and that the financial statements agree or reconcile to the underlying accounting records.

In addition to the fundamental requirement addressed above, AU-C section 230 requires that the working papers reflect the following:

- The identifying characteristics of the specific items or matters tested
- Abstracts or copies of significant contracts or agreements inspected

- The nature of significant findings or significant issues discussed with management, those charged with governance, or others, along with when and with whom the discussions took place
- How information inconsistent with the auditor's final conclusion regarding a significant finding was addressed
- The justification for any departure from a presumptively mandatory requirement and how the procedures applied instead were sufficient to achieve the requirement's intent
- For any new or additional audit procedures or new conclusion after the auditor's report date
  - The circumstances involved
  - The new or additional procedures or new conclusion, including new evidence obtained, and the effect on the report
  - When and by whom the change was made and reviewed
- The date of the report release

The audit documentation has to be accumulated into an audit file within 60 days of the report release date. The documentation has to be retained for at least five years, and the confidentiality of client information must be maintained. No items should be deleted from the file during the retention period. Any changes to audit documentation after the documentation has been assembled must indicate the reason for the change and when and by whom they were made.

## Other guidance

The following guidance also establishes specific working paper requirements:

- AU-C section 210, *Terms of Engagement*, requires the auditor to obtain an engagement letter from the client and, when using an engagement letter executed in a prior year, document a periodic reminder to the client about the terms of the engagement when the terms have not changed or issue a new letter if they have.
- AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With GAAS*, requires documentation regarding considerations, and conclusions regarding compliance with ethics requirements, including independence, conclusions reached about engagement acceptance or continuance, consultations undertaken during the course of the engagement, and the engagement quality control reviewer's procedures and conclusions.
- AU-C section 240 *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to document the auditor's consideration of the risk of fraud, identified fraud risks, the responses to fraud risks, and their results, including those designed to address the risk of management's override of controls, communications about fraud made to the entity, and any conclusion overcoming the presumption that revenue recognition is a fraud risk.
- AU-C section 250, *Consideration of Laws and Regulations in a Financial Statement Audit*, requires the documentation of identified or suspected noncompliance with laws or regulations and the results of discussions with the client or others.
- AU-C section 260, *The Auditor's Communication With Those Charged With Governance*, requires documentation of required communications made orally or the retention of those made in writing.
- AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*, requires documentation of any oral communications of control weaknesses not considered significant deficiencies or material weaknesses.
- AU-C section 300, *Planning an Audit*, requires the auditor to document the overall audit strategy, the audit plan, and any significant changes to them made during the audit and the reason for changing them.

- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to document (1) the required discussion among the engagement team regarding the financial statements' susceptibility to misstatement; (2) key elements of each element of the understanding of the entity and its environment, its components of internal control, the sources of the information, and the risk assessment procedures applied; (3) risks of material misstatement at the financial statement and relevant assertion levels; and (4) significant risks and related controls.
- AU-C section 320, *Materiality in Planning and Performing an Audit*, requires the auditor to document materiality for the financial statements taken as a whole, any materiality levels determined for particular items in the financial statements, performance materiality, and any revision of materiality amounts.
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, require the auditor to document (1) the responses to risks of material misstatement at the financial statement and relevant assertion level and the results of those procedures (including the conclusions if not otherwise clear); (2) conclusions reached about using tests of controls performed in a prior year, when the auditor decides to do so; (3) the basis for any decision not to confirm accounts receivable when they are material; and (4) that the financial statements agreed with or reconcile to the financial records.
- AU-C section 450, *Evaluation of Misstatements Identified During the Audit*, requires documentation of the amount below which misstatements would be considered clearly trivial, all misstatements accumulated during the audit and whether they were corrected, the auditor's conclusion about whether uncorrected misstatements are material individually or in the aggregate and the basis for that conclusion.
- AU-C section 501, *Audit Evidence – Specific Considerations for Selected Items*, requires the auditor to document the basis for any decision not to communicate with legal counsel when a potential for a material misstatement due to litigation, claims, or assessments exists.
- AU-C section 520, *Analytical Procedures*, requires the auditor to document the expectations used in analytical procedures (and unless otherwise readily determinable the basis for them), results of the comparison between recorded amounts and expectations, and any additional audit procedures regarding investigation of unexpected differences and their results.
- AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, calls for documentation of accounting estimates that represent significant risks, the basis for the auditor's conclusion about the reasonableness of their amounts and disclosures, and any indicators of possible management bias.
- AU-C section 550, *Related Parties*, requires documenting the names of identified related parties and the nature of the relationships.
- AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires documentation of conditions or events indicating a going concern problem, particularly significant elements of management's plans to overcome the problem the auditor's work in evaluating management's plans, the auditor's conclusion about whether substantial doubt remains, the possible effect on the financial statements and adequacy of disclosures (if the doubt remains) or the need to disclose the conditions and management's mitigation plans (if the doubt is alleviated), and the auditor's conclusion with respect to the effect on the audit report.
- AU-C section 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, requires the group auditor to document (1) an analysis of components indicating which are significant and the type of work performed on the components; (2) the components for which reference to the component auditor's reports will be made in the audit report on the group financial statements; (3) written communications with the component auditors about the group auditor's requirements; and (4) the financial statements and auditor's report for any

components for which reference to the component auditor will be made in the group auditor's report and, when the component auditor's report does not state conformity with GAAS or PCAOB standards, the basis for the group auditor's determination that the work complied with relevant requirements of GAAS. When the group auditor assumes responsibility for the component auditor's work, the documentation also has to include the nature, timing, and extent of the group engagement team's involvement in the component auditor's work on significant components, including any review of the component auditor's documentation and the resulting conclusions.

- AU-C section 610, *Using the Work of Internal Auditors*, requires an auditor who uses the work of the internal audit function in obtaining audit evidence to document (1) the results of the evaluation of the function's objectivity, competence, and application of a systematic and disciplined approach, (2) the nature and extent of the work used and the basis for the decision to use it, and (3) the audit procedures used to evaluate the adequacy of the work used. An auditor who uses internal auditors to provide direct assistance is required to document (1) the evaluation of the objectivity and competence of the internal auditors providing direct assistance, (2) the basis for the decision regarding the nature and extent of their work, (3) the nature and extent of the auditor's review of their work, and (4) the working papers prepared by internal auditors providing direct assistance. In either case, the auditor is required to document the evaluation of whether the auditor is sufficiently involved in the audit given the auditor's sole responsibility for the audit opinion.
- AU-C section 915, *Reports on the Application of Requirements of an Applicable Financial Reporting Framework*, requires that, when the reporting accountant does not consult with the continuing accountant, he or she document the rationale for not consulting.
- AU-C section 930, *Interim Financial Information*, requires the auditor to prepare working papers for reviews of interim financial information that documents the nature, timing, and extent of review procedures performed; the results of the procedures and evidence obtained; significant findings or issues that arose and the conclusions reached on them, including significant professional judgments made, and oral and written communications required by the standard.
- AU-C section 935, *Compliance Audits*, requires an auditor doing compliance audits pursuant to *Government Auditing Standards* to document the following regarding the compliance audit: the risk assessment procedures performed, including those related to gaining an understanding of internal control over compliance; responses to assessed risks of material noncompliance, the procedures performed to test compliance with the applicable requirements and the results of those procedures, including any tests of controls over compliance, materiality levels and the basis on which they were determined; and how he or she complied with the specific governmental audit requirements that are supplementary to GAAS and *Government Auditing Standards*.

### Other factors affecting working papers

Individual firms often have specific working paper policies that are expected to be followed on every audit. These are in accordance with quality control standards.

The AICPA's Practice Monitoring Program Manuals contain several engagement checklists for use by peer reviewers. As a part of an on-site peer review, the reviewer examines the firm's working paper documentation.

Requirements of other bodies may apply in specific instances, for example, the fieldwork standards in *Government Auditing Standards* (Yellow Book), which are to be followed in addition to GAAS.

The Code of Professional Conduct also establishes documentation requirements. Ethics Interpretations 1.210.010 and 1.295.050 under the "Independence Rule" (AICPA, *Professional Standards*, ET sec 1.200.001) require specific documentation regarding independence.

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## Knowledge check

1. Which statement is NOT correct?
    - a. Working papers are required in every audit engagement.
    - b. There are no GAAS requirements for working paper form or content.
    - c. The accountant always has to include working papers in compilation engagements.
    - d. Although standards may require documentation of certain things, how they are documented is a matter of the practitioner's judgment.
- 

## Audits performed under PCAOB standards

Audits of public companies are performed in accordance with the reorganized standards of the PCAOB, not GAAS. The requirements of PCAOB standards are similar but not identical to GAAS.

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## Other professional services: Summary of standards

Professional services other than auditing are governed by various standards. Although this course focuses on the auditing process, you will most likely be called upon to perform a variety of services for your clients. A summary of working paper documentation requirements for other services is presented in exhibit 1-1.



## Exhibit 1-1 Working paper documentation requirements

### Other professional services

Service	Applicable standard	Working papers required?
Preparation of financial statements	Statements on Standards for Accounting and Review Services (SSARS)	Yes
Compilation of financial statements	Statements on Standards for Accounting and Review Services (SSARS)	Yes
Review of financial statements	Statements on Standards for Accounting and Review Services (SSARS)	Yes
Attestation engagements	Statements on Standards for Attestation Engagements (SSAE)	Yes
Consulting services	Statements on Standards for Consulting Services	No <sup>1</sup>
Tax services	Statements on Standards for in Tax Services	No
Valuation services	Statement on Standards for Valuation Services	Yes

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<sup>1</sup> MAS Practice Administration Aid No. 1 discusses working papers, but the standard itself does not explicitly require them.

# The nature of working papers

Working papers document the procedures followed, the tests performed, information obtained, and conclusions reached during the audit. They are the foundation for the auditor's opinion. They show how the auditor considered the basic questions that face every auditor in every audit: How much evidence is enough? How much importance should be attributed to evidence accumulated? How should problems of conflicting information be resolved?

The staff person is closest to the action, yet it is the manager and partner who ultimately must make the professional judgments, and they can only do so based on the working papers that the staff prepares.

Even the staff person who prepared the working papers will have trouble remembering what he or she did when reviewing them a year or two later, in connection with subsequent years' audits, peer reviews, or litigation, if the working papers are not complete.

Working papers must be adaptable to the needs of audits of diverse types of clients, to individual and firm practitioners with personal and firm preferences, and to the dictates of professional and regulatory organizations.

The staff person's working papers should try to communicate accurately to the in-charge, manager, and partner what he or she did and found. The working papers should be complete and accurate and able to stand on their own.

Documentation includes anything that the auditor documents to enable him or her to render an opinion on the financial statements. The auditor generally determines the nature and extent of working papers. They generally include, for example, audit programs and checklists, analysis schedules, confirmation letters, copies or abstracts of contracts, minutes of meetings, correspondence (including e-mail) regarding significant issues, and memos written by the auditor documenting his or her procedures or conclusions. It might also include, for example, electronic data or videocassettes.

The nature and extent of documentation depends on the following factors:

- Risk of material misstatement associated with the assertion, or account or class of transactions
- Extent of judgment involved in performing the work and evaluating the results
- Nature of the auditing procedure
- Significance of the evidence obtained to the assertion being tested
- Nature and extent of exceptions identified
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed

# Summary

- Working papers are required by GAAS. Although there are some specific requirements, the form and content of actual working papers are generally left to the auditor's judgment.
- AU-C section 230 requires that the working papers show the scope of work and who did it, findings and conclusions, and that the financial statements agree or reconcile to the underlying records.
- Other requirements, such as those relating to practice monitoring and audits of government agencies, also establish minimum working paper requirements in some instances.
- Working papers document the work done. They are important during the audit to control the quality of work done and after the audit to demonstrate adherence to standards.





## Chapter 2

# Preparing and Maintaining Working Papers

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### Learning objectives

After completing this chapter, you should be able to do the following:

- Identify the contents of working papers.
  - Recognize the basic concepts of working paper file completion, ownership, and retention.
- 

### Introduction

Generally accepted auditing standards (GAAS) establishes the basic rules regarding the comprehensiveness of the working paper file and administrative requirements for completing and maintaining audit files. In complying with the basic rules, firms, and even individual auditors within the same firm, often differ in specific working paper technique. Nonetheless, there are some general rules about working papers that are commonly followed throughout the profession. Those rules concern

- The types of working papers that are prepared;
- What they look like; and
- How they are filed and indexed.

# What working papers are

Working papers consist of anything that the auditor retains to document the audit and his or her compliance with professional standards. Properly designed working papers can help to identify controls that may be the basis for restricting substantive procedures or to identify risks that suggest the need to expand them. They may also provide information for suggestions for improvements to the client's internal control.

Working papers should

- Corroborate amounts appearing in the financial statements, not merely report them;
- Record the scope and results of reviews, discussions, tests, and other procedures required in an audit engagement;
- Record significant audit findings, actions taken in response to those findings, and the basis for conclusions reached;
- Provide a basis for supervisory review of work done;
- Provide information to evaluate the job performances of the staff who prepare them; and
- Provide a starting point for the subsequent year's audit.

Because working papers are intended to communicate efficiently to what the auditor did and found, the auditor should strive for completeness and clarity. Therefore a legitimate goal in preparing audit working papers is to generate as few questions as possible from whoever reviews them.

# What should be in the working paper file

While filing systems vary among firms, AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), requires that all the documentation for a specific audit be assembled in an audit file. Thus, all the working papers for an audit should be accumulated together, though they might be in separate binders, folders, electronic documents, or in the case of a client with multiple locations, offices.

When procedures applied are relevant for more than one engagement (for example, tests done on a benefit-plan audit that also provide evidence for the audit of the sponsor's financial statements or audit procedures done on a joint venture that are relevant to one of the venture partner's financial statements) the documentation does not have to be duplicated in the audit file. It can, instead, merely be cross-referenced.

Matters such as quality control or independence are usually documented separately because they apply to the operation of the firm rather than the audit. But if there is a specific matter that relates directly to the audit that documentation should be included in the audit file.

The form of the working papers is generally a matter of auditor judgment, which is based on

- The nature of the auditing procedures to be performed;
- The identified risk of material misstatement associated with the assertion, or account or class of transactions, including related disclosures;
- The extent of judgment involved in performing the work and evaluating the results;
- The significance of the audit evidence obtained to the assertion being tested;
- The nature and extent of exceptions identified; and
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or evidence obtained.

It is not practicable to document everything the auditor does or sees, nor to document every inquiry, response, or conversation the auditor has with the client. Accordingly, the auditor must be selective of what is included.

The results of audit procedures should be stated or readily determinable from the documentation of the work performed. Some firms and individual auditors choose to state a conclusion as a result of each test. This forces staff auditors to analyze the work they have done and provides a roadmap for reviewers. However, an explicit conclusion is not required by GAAS as long as the results of the tests are clear.

For example, if the test involves comparing 10 items in inventory to vendor invoices and the tickmarks make it clear that each of the 10 agreed, it is unnecessary under GAAS to explicitly state a conclusion. If one item did not agree to the invoice, it would not be necessary under GAAS to state a conclusion if the working paper indicated the difference, the cause, and the effect on the results of the test (for example, the projection of the misstatement found in a sample to the population from which it was taken and a proposed adjusting entry).

Conclusions drawn from work on estimates or as a result of analytical procedures are less clear and are more likely to require explicit conclusions.

If you do state a conclusion, take care not to overstate the assurance provided by the test. For example, a test done as a part of a financial statement audit generally provides a basis for opining only on the financial statements as a whole, not on each individual element, account, or item in the financial statements. There might be an insufficient basis for a conclusion that the account balance tested is stated in conformity with generally accepted accounting principles. In addition, any conclusion should be free of vague judgmental adjectives such as "good" or "bad."

There is no need to copy and include all audit evidence examined as that would result in impractically large files. It is generally sufficient to refer to the specific client documentation examined. Copies or abstracts of client records should be included if they would be necessary for an experienced auditor with no previous connection with the audit to understand the work done and conclusions reached.

Auditing standards create requirements that auditors are expected to follow. AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With GAAS* provides two levels of requirements: unconditional requirements (denoted by the word, "must") and presumptively mandatory requirements ("should"). The auditor may not depart from an unconditional requirement. If the auditor departs from a requirement that is presumptively mandatory, the working papers should document

- The justification for the departure; and
- How the alternative procedure performed instead was sufficient to achieve the intent of the requirement.

Over the course of an audit, auditors often accumulate more information than they need. And often they start working papers that they subsequently revise or find to be unhelpful because of changes in approach or initial misunderstanding of circumstances. It is appropriate to dispose of unnecessary working papers or other information. The auditor need not retain in audit documentation superseded drafts of working papers or financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents. However, information should not be discarded merely because it does not support the amounts in the financial statements.

Oral explanations may be used by the auditor after the fact to clarify audit documentation but they do not represent sufficient support for the auditor's work or conclusions. That is, oral explanations may clear up ambiguities but do not substitute for appropriate documentation.

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## Knowledge check

1. Conclusions regarding the success of tests documented in working papers
  - a. Should be summarized on the audit program (audit plan).
  - b. Should be explicitly stated.
  - c. May be unstated if obvious from the work performed.
  - d. Should be phrased in terms of whether the item is in accordance with GAAP.

# Types of working paper files

Many auditors divide their working papers into two general types: permanent and current. Exhibit 2-1 provides examples of permanent and current working paper files:

- *Permanent files* – Consist of matters that are important to each year's audit, but the information is not expected to change markedly from year to year.
  - Examples include agreements and carryforward schedules; and
  - Permanent working papers used in each year's audit, but filed separately from the current working papers.
- *Current files* – The working papers that the auditor prepares to support the opinion on the current year's financial statements (generally include the trial balance and tests done on current year financial amounts).
- *Lead or grouping schedules* – Show how accounts are grouped for presentation in the financial statements (for example, showing how the financial statements are prepared, ensuring the presentation is consistent from year to year, and applying analytical procedures).
- *Detail schedules* – Show the amounts that make up the balance in each account tested and the tests applied to them. These schedules might analyze the activity in the account, reconcile the account balance to another source, or show the components of the final balance. (Ordinarily, the test procedures applied to each amount would be described on the working paper as well.).
- *Some current working papers show only the auditor's tests* – Might consist of memorandums describing the tests and results, copies of independent confirmations, amounts calculated in analytical procedures, or independent calculation of an amount estimated by the client.

Some working papers might be either permanent or current, depending on an individual firm's approach. For example, some firms file the understanding of internal control in a permanent file, and others file it with the current year's tests of controls. The decision to place a particular working paper in a current or permanent file is important only to the extent that a firm is consistent. The audit staff must be able to find specific working papers when it needs them.

When the auditor uses electronic working papers, the physical placement of the working papers becomes less important. But many auditors maintain a combination of electronic and hard copy working papers.



## Exhibit 2-1 Examples of the contents of permanent and current working paper files

A *permanent file* generally includes some or all of the following:

- Copies or extracts of articles of incorporation and bylaws
- Information on the client's industry
- Locations of client's facilities
- Current contracts and agreements, such as those for
  - Notes and mortgages payable;
  - Leases;
  - Labor negotiations;
  - Employment contracts for key people; and
  - Pensions and profit-sharing plans.
- Information on the equity accounts, such as descriptions of classes of stocks, warrants, and options
- Client's accounting policies and procedures
- Carryforward analyses of accounts and items that are relevant to the ongoing aspects of audit engagements, such as those for
  - Fixed assets;
  - Goodwill;
  - Long-term debt;
  - Cumulative retained earnings; and
  - Prior years' tax returns.

A *current file* generally includes

- The financial statements and auditor's opinion;
- Minutes of the meetings of the board of directors and shareholders;
- Legal matters, such as contracts or opinions;
- The working trial balance;
- Adjusting and reclassifying journal entries;
- Planning documents;
- Audit programs;
- Tests of controls; and
- Analyses of the general ledger accounts and substantive tests applied to them.

Depending on the size of the client, there may be separate files for accounts receivable and payable confirmations, inventory observations, general matters, or any other separate category.

# What every working paper should contain

- The working paper heading should contain the following:
  - Name of the client
  - A title describing the working paper or its contents
  - The date of the financial statements being audited
- An indication of preparation and review:
  - The name or initials of the preparer should be shown on the working paper, as well as the date it was completed.
  - If the client prepared the schedule, the working paper should reflect that fact (of course, the auditor still must audit it).
  - The name or initials of the reviewer and the date of the review
- The source of the information presented, such as the cash disbursements journal or the accounts receivable detail ledger. Although the source may be obvious to the staff member preparing the working paper and his or her immediate supervisor, it is still important to show this on the working paper for the benefit of (1) other reviewers who may not be as familiar with the engagement; and (2) the staff accountant next year who will appreciate knowing where, or from whom, the information was obtained.

Although this is not widely done, some auditors also indicate the purpose of the working paper, for example, "This workpaper compares the general ledger balances to the operating statements and to ensure that all work reported as done is recorded in the general ledger." Even though the working paper and the objective of the work should be clear based on the working paper itself and the audit program, an explicit statement makes working paper review more efficient.

AU-C section 230 requires only that the documentation show who performed and reviewed the work and when. It does not explicitly require that this information appear on each working paper (it could, for example, appear on the audit program or a memo). Nonetheless, common practice is to initial and date each working paper.

The nature and extent of documentation depends on the following factors:

- Risk of material misstatement associated with the assertion, account or class of transactions, or disclosure
- Extent of judgment involved in performing the work and evaluating the results
- Nature of the auditing procedure
- Significance of the evidence obtained to the assertion being tested
- Nature and extent of exceptions identified
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed

There is a subtle difference between documenting the evidence and documenting enough for reviewers to understand the evidence obtained. Copying an invoice or a contract documents the evidence; saying the amount agrees to the invoice or abstracting a contract usually provides sufficient documentation for a reviewer to understand the evidence obtained.



The nature and extent of the work performed should be indicated in sufficient detail to allow a supervisor to understand the nature of tests, timing of tests, extent of tests, results of tests, and evidence obtained, through narrative description, symbols or tickmarks, or a combination. Exhibit 2-2 illustrates some commonly used tickmarks. If tickmarks are used the following apply:

- They can save the auditor time and space by explaining procedures used in several areas in a centralized location rather than on each working paper. For example, a standard tickmark indicating that column totals have been footed can be used throughout the working papers and explained in one place, rather than on each page.
- Each tickmark should be clearly explained for the working paper to be clear to the reviewer. The explanation may be located on the working paper itself or in a separate legend that is clearly cross-referenced on the working paper.
- Tickmarks should be simple, distinctive, and clear so that they can be quickly written by the preparer and easily discerned by the reviewer.
- Other matters, such as standardization of tickmarks and use of color in tickmarks should also be considered.



### Exhibit 2-2 Tickmarks

Standardized tickmarks save time and are easily understood by reviewers. Here are examples of standardized tickmarks:

F	Footed
CF	Crossfooted
Ç	Calculation checked and agreed
PY	Agreed to prior-year's working papers
TB	Agreed to trial balance
GL	Agreed to general ledger
R	Agreed to report
C	Agreed to confirmation

Other tickmarks should generally be simple, distinctive, and easy to make. Some common tickmarks include the following:

- Ⓐ Used to explain procedures and findings for individual amounts.
- ① Used to cross-reference amounts within a workpaper. Cross references between working papers can be done by simply writing the other working paper's number by the amount to be cross-referenced.
- T Traced to (source).



## Exhibit 2-2 Tickmarks (continued)

Other common tickmark symbols include the following. They are most useful when ticking items off a long list, for example, keeping track of which outstanding checks cleared the bank during the subsequent period.

⌘

★

✓

×

◎

Some auditors like standardized tickmarks because they believe that approach is efficient; others argue that standardized tickmarks are inflexible and therefore impractical.

Some auditors believe that using colored tickmarks make the tickmarks more distinctive and easier to identify; others believe that changing colors is a waste of time and the color distinction is generally lost in photocopying.

Some auditors using computer-generated working papers create tickmark explanations using the "comments" feature of the software. This can create difficulties later on if comments do not print when hard copies of the working papers are printed. A better idea for electronic tickmarking is to accumulate all tickmark comments onto one sheet (assuming the work is done in Excel), and type the symbol where wanted among the actual audit and review work (with the related tickmark comment – if needed – documented on the separate tickmark sheet within the file).

Doubts raised during the course of testing should be resolved, and working papers should indicate the resolution. An unresolved exception may suggest an inadequate audit. If the auditor is called away from the engagement before resolving all matters, it is a good idea to provide the in-charge accountant with a list of open items.

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## AICPA working paper practice aid

The AICPA has developed a practice aid intended to help auditors document the results of testing in accordance with the requirements of AU-C section 230. The practice aid, which can be found at [www.aicpa.org/pcps/quality](http://www.aicpa.org/pcps/quality), presents a working paper template in Excel format, as well as examples of how it would be used for analytical procedures, tests of details, and tests of controls.

The practice aid is not authoritative but can help the auditor in documenting audit work. It has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to

be appropriate. However, it has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

The appendix to this chapter presents the working paper template.

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## Indexing and cross-referencing working papers

- Working papers are generally indexed and cross-referenced.
- Indexing systems are a matter of firm preference, but most firms index their current-file working papers. Most systems use either numbers or letters to designate individual topics, and they number pages consecutively within the topic. (For example, tests of accounts receivable might be designated as section F or section 1300, and working papers in that section might be numbered F-1, F-2, or 1301, 1302, and so on.)
  - Working papers can be numbered and indexed as they are prepared or after the work is completed.
  - Working papers are generally arranged to show the flow of information from the financial statements (or trial balance) to individual account balances or classes of transactions tested.

# Working paper control

Controls should be implemented by the auditing firm to ensure that inappropriate changes to working papers are not made. The controls should include

- Clearly determining when and by whom audit documentation is created, changed, or reviewed;
- Protecting the integrity of the information at all stages of the audit, especially when the information is shared with the audit team or transmitted to other parties electronically;
- Preventing unauthorized changes to documentation; and
- Allowing access by the audit team and other authorized parties as necessary to properly discharge their responsibilities.

The auditor also should adopt reasonable procedures to prevent unauthorized access to the audit documentation. Such procedures often include physical security, such as storing working papers in locked trunks, and electronic security, such as requiring passwords to access electronic files.

# Completing the working paper file

Within 60 days of the release of the audit report, the auditor should complete the assembly of the audit file. The report release date is required to be documented in the working papers.

*Between the date of the auditor's report and the documentation completion date*, the auditor is allowed to

- Complete the documentation and assembly of audit evidence that the auditor has obtained, discussed, and agreed with relevant members of the audit team prior to the date of the auditor's report;
- Perform routine file-assembling procedures such as deleting or discarding superseded documentation and sorting, collating, and cross-referencing final working papers;
- Sign off on file completion checklists prior to completing and archiving the audit file; and
- Add information received after the date of the auditor's report, for example, an original confirmation that was previously faxed.

In some cases new information, such as previously unknown facts or realization that an important auditing procedure was inadvertently omitted, comes to the auditor's attention *after the date of the auditor's report* indicating the need for additional audit procedures or causing the auditor to draw new conclusions. In those situations the auditor should add documentation to the audit file indicating the additional work done. The new documentation should show

- The circumstances encountered;
- The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
- When and by whom the changes to the working papers were made and reviewed.

In circumstances other than those described directly above (whereby new information results in the need for additional audit procedures or results in new conclusions), when an auditor finds it necessary to modify existing audit documentation or add new documentation *after the documentation completion date*, the auditor should, regardless of the nature of the modifications or additions, document

- The specific reasons for making the changes; and
- When and by whom they were made and reviewed.

*After the documentation completion date* the auditor must not delete or discard any documentation from the audit file until at least five years after the report release date.

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## Knowledge check

2. After 60 days following the release of the audit report
  - a. Nothing can be added to the audit file.
  - b. Nothing can be deleted from the audit file.
  - c. No additional procedures may be performed.
  - d. The files should be destroyed.

# Computer-prepared working papers

Computers are commonly used to prepare the following types of working papers:

- Audit programs
- Trial balances and lead schedules
- Account analysis spreadsheets
- Memorandums

Computers are also used in drafting financial statements, management letters, and other communications.

Although using a computer to help prepare working papers may make the job easier and change the method of working paper preparation, the auditor must still comply with AU-C section 230 and other specific working paper standards. Basic preparation rules and techniques are no different for computer-prepared working papers than for manually prepared ones.

Many auditors have incorporated computers into working paper preparation. Some use commercial products such as Practitioners Publishing Company's Engagement Manager, Caseware Working Papers, or ePace Engagement. Others merely automate working paper preparation by using word processing, electronic spreadsheet, database, and other common application software.

The advantages to electronic working papers include the following:

- The ability to import client documents and work (reformat, analyze, and so on) on them in electronic form
- Partners or other supervisors can review them from remote locations without removing the physical documents from the engagement site.
- Data can be easily extracted for other analysis or other purposes such as tax return preparation.
- Data can be synchronized through a network connection, ensuring all audit staff have up-to-date working paper files.
- Documents within the electronic file can be easily hyperlinked.
- Effectiveness of some types of analyses can be increased; for example, trend lines or regressions can be easily produced to be used as a basis for expectations in analytical procedures.
- Issues regarding hard-to-read copies or handwriting are eliminated.

Some firms go entirely paperless. They scan in all hardcopy documents not already in machine-readable form.

Others keep a separate file for hard-copy documents instead of scanning them in. These auditors believe that scanning everything might be inefficient and they prefer to retain original representation letters, confirmations, and other documents.

The purpose of automating working papers is to increase efficiency. In using electronic working papers, therefore, ensure that the time savings outweigh the incremental time and effort needed to prepare them.

- Hidden inefficiencies include the following:
  - Time needed to create and debug spreadsheets and other data-managing programs
  - Equipment and logistical problems such as finding outlets and extension cords, using appropriate printers and cables, and the need for additional supplies
  - Time, expertise, and resources needed to download data from the client's computers to the auditor's

A hidden danger in the use of automated working papers is the risk that working papers can be changed with relatively little record of the change. Commercial programs may have controls over this.

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## Knowledge check

3. Electronic working papers
  - a. Generate fewer questions.
  - b. Are not as easy to alter.
  - c. Cannot be considered audit documentation.
  - d. Are intended to create efficiencies.

# Summary

Working papers should

- Corroborate the amounts in the financial statements, not merely report them;
- Record the scope and results of reviews, discussions, tests, and other procedures required in audit engagements;
- Record significant audit findings, action taken in response to those findings, and the basis for conclusions reached;
- Provide a basis for supervisory review of work done;
- Provide information to evaluate the job performances of those who prepare them; and
- Provide a starting point for the subsequent year's audit.

Although there is no specific filing system required by GAAS, working papers generally contain permanent files, which are relevant to the client for every year, and current files, which are relevant to the year under audit.

Every working paper should contain

- An indication of the client, year under audit, and who prepared it;
- The source of the information presented;
- The nature, timing, and extent of the work performed;
- The conclusions reached by the auditor;
- Appropriate cross-references to other working papers; and
- Appropriate indexing.

Working paper documentation must be completed within 60 days of the release of the audit report. Nothing can be deleted after that time; additions after that time are subject to special documentation rules.



## Appendix A

# AICPA AUDIT WORKPAPER TEMPLATE

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**This appendix is provided for supplementary purposes only and is not required reading for this course or earning the related CPE credits.**



# INSTRUCTIONS

1

This practice aid is intended to help auditors document the results of testing while meeting the requirements of AU-C section 230, *Audit Documentation*. This publication is an *other auditing publication* as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, Professional Standards). Other auditing publications have no authoritative status; however, they may help you, as an auditor, understand and apply certain auditing standards.

2 In applying the auditing guidance included in an other auditing publication, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

Client Name 



  
 Working Paper Title 



  
 Balance Sheet Date 



  
 Prepared By Client?

Working Paper # 



  
 Preparer 



  
 Date Completed 



  
 Reviewer 



  
 Date Reviewed

#### Objective

*If not addressed elsewhere in the audit file (e.g. in the audit program), describe the nature of the procedures to be performed and the assertion(s) being testing.*

#### Results of Procedures and Evidence Obtained

*In this section, document the results of the audit procedures performed. The form and content of the documentation will depend on the nature of the procedures performed; however, the documentation must be sufficient to enable an experienced auditor, having no previous connection to the audit, to understand the extent of the auditing procedures performed, the results of those procedures, and the audit evidence obtained.*

##### Documentation should

- Include the identifying characteristics of the specific items tested;
- Demonstrate that accounting records agree or reconcile with the audited financial statements or other audited information; and
- Include significant findings or issues, as well as actions taken to address them (including any additional evidence obtained).

*Tickmarks can save the auditor time and space by explaining procedures performed in one centralized location. Commonly used tickmarks*

#### Tickmark Legend

- F** Footed
- CF** Crossfooted
- Ç** Calculation checked and agreed
- PY** Agreed to prior-year's working papers
- TB** Agreed to trial balance
- GL** Agreed to general ledger
- R** Agreed to report
- C** Agreed to confirmation
- T** Traced to *(describe source)*
- (A) (B) (C) (D)** *Use to explain procedures and findings*
- (1) (2) (3) (4)** *Use to cross-reference items within the working paper*
- ✓** *Use to indicate a test was performed and no exceptions were noted*

#### Conclusion

*Document the basis for the final conclusions reached.*

Client Name	Example Company
Working Paper Title	Planning Analytics - Sales and CGS
Balance Sheet Date	12/31/20x6
Prepared By Client?	No

Working Paper #	EX-1
Preparer	ABC
Date Completed	3/15/20x7
Reviewer	DEF
Date Reviewed	3/31/20x7

### Objective

To analyze changes in account balances and other related metrics in order to identify areas that may represent specific risks relevant to the audit.

### Results of Procedures and Evidence Obtained

#### Expectations

- ① Example Company is the world's premier provider of widgets. Widget demand has been strong this year, with 10% growth in the industry during 20x6. We expect to see a 10 - 15% increase in sales, with a similar increase in accounts receivable.
- ② Per inquiry of Joe Smith, COO, increased demand has led Example Company to expand their capacity, purchasing a new production facility for \$2M and financing the full amount with a long-term note payable. Because the note was issued in December 20x6, any increase in interest expense is expected to be minimal.
- ③ The COO also indicated that Example Company has adopted a new inventory management approach which has improved their inventory turnover by 10%.

#### Trend Analysis

	Current year		Prior year	\$ Change	% Change		Days Sales in Receivables
Sales	2,500,000	FS	2,175,000	PY	325,000	14.94%	Current year 161 days
Cost of goods sold	1,780,000	FS	1,566,000	PY	214,000	13.67%	Prior year 141 days
Gross margin	720,000	FS	609,000	PY			% increase 14.18%
Gross margin as a % of sales	28.80%		28.00%				Inventory turnover
Selling expenses	230,000	FS	184,000	PY	46,000	25.00%	Current year 1.84 times
Interest expense	43,000	FS	42,000	PY	1,000	2.38%	Prior year 2.05 times
							% decrease 10.24%

#### Balance Sheet Ratio Analysis

	Current year		Prior year
Accounts receivable, net	1,100,000	FS	843,000
Inventory	1,000,000	FS	832,000
Notes payable	437,000	FS	437,000

#### Tickmark Legend

- ☑ Calculation checked and agreed  
 FS Agreed to financial statements  
 PY Agreed to prior-year's working papers

- ① Increase in sales and days sales in receivables of 15% and 14%, respectively, is consistent with expectations.
- ② Slight increase in interest expense is consistent with expectations. However, the lack of any change in notes payable indicates the \$2M note which Example Company entered into in December may not be properly recorded. This warrants further exploration on in the notes payable section of the audit file at working paper ###.
- ③ Change in inventory turnover is consistent with expectations.

### Conclusion

Changes in revenue, cost of goods sold, and related accounts were consistent with expectations with the exception of notes payable, which showed no change despite a new \$2M note signed in December. Additional consideration appears on working paper ###.

Client Name	Example Company 2
Working Paper Title	Short-Term Notes Receivable
Balance Sheet Date	12/31/20x6
Prepared By Client?	No

Working Paper #	EX-2
Preparer	GHI
Date Completed	2/18/20x7
Reviewer	JKL
Date Reviewed	2/25/20x7

### Objective

To verify that the notes receivable appearing on the balance sheet exist, Example Company 2 has rights to them, and their valuation is appropriate.

### Results of Procedures and Evidence Obtained

Customer's Name	Interest Rate	Issue Date	Maturity Date	Face Amount		Accrued Interest 12/31/20x6	
Customer A	7%	11/17/20x6	2/19/20x7	112,000.00	T, C	945.00	Ç
Customer B	9%	9/15/20x6	3/30/20x7	330,000.00	T, C	8,707.00	Ç
Customer C	10%	9/1/20x6	1/5/20x7	72,000.00	T, C	2,387.00	Ç
Customer D	8%	7/24/20x6	3/18/20x7	91,000.00	T, C	3,191.00	Ç
Customer E	9%	8/21/20x6	1/11/20x7	54,000.00	T, C	1,758.00	Ç
Customer F	11%	10/30/20x6	4/29/20x7	95,000.00	T, C	1,775.00	Ç
Customer G	8%	12/15/20x6	6/30/20x7	219,000.00	T, C	768.00	Ç
				<u>973,000.00</u>		<u>19,531.00</u>	
				<b>F, TB</b>		<b>F, TB</b>	

### Tickmark Legend

- T** Traced face amount, interest rate, issue and maturity dates to note receivable documents
- C** Agreed to confirmation
- Ç** Calculation checked and agreed
- F** Footed
- TB** Agreed to trial balance

### Conclusion

Verified existence and rights by examining notes receivable document. Based on 100% confirmation and inquiry of controller (who confirmed collectibility of all accounts), valuation appears appropriate and no loss provision appears necessary.



Client Name	Example County
Working Paper Title	Single Audit - Compliance and Control Testing
Balance Sheet Date	6/30/20x7
Prepared By Client?	No

Working Paper #	EX-3
Preparer	MNO
Date Completed	9/30/20x7
Reviewer	PQR
Date Reviewed	10/15/20x7

*This workpaper is only intended to illustrate auditor documentation for a dual-purpose test of compliance and internal control over compliance for several compliance requirements. Auditors may refer to the AICPA Audit Guide, Government Auditing Standards and Single Audits, to gain an understanding of the other types of detailed documentation needed to support a single audit.*

#### Objective

This working paper documents the auditor's tests of Example County's  
- Compliance with allowable cost, allowable activities and earmarking requirements for the Community Development Block Grant; and  
- Controls over compliance with those requirements.

#### Results of Procedures and Evidence Obtained

**Note:** Audit Firm obtained a schedule of expenditures from Joe Client, Example County's Community Development Block Grant (CDBG) Program Manager. The schedule broke down the CDBG expenses into two groups: (1) expenditures by the county (further broken down by payroll and other than payroll) and (2) funds which were passed through to subrecipients. From this schedule, Audit Firm used the county's expenditures and working paper (###) to select a sample. Audit Firm then took the schedule that Joe prepared and detailed what type of expenditures the county was making (other than payment to subrecipients - see subrecipient monitoring testing) and allocated the sample size based on each expenditure's percent of total county expenditures.

Vendor Name	Description	County		IC	IC	Comp	IC	Comp	IC	Comp	IC	IC	Comp
		paid date	Amount	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
Service vendor 1	Admin Services	7/24/20X6	19,873.38	x		x	x	x			x		x
Service vendor 2	Admin Services	8/13/20X6	19,937.88	x		x	x	x			x		x
Service vendor 3	Project 1	9/2/20X6	156,763.84	x		x	x	x			x		x
Service vendor 3	Project 1	9/22/20X6	47,749.48	x		x	x	x			x		x
Service vendor 3	Project 1	10/12/20X6	267,900.39	x		x	x	x			x		x
Service vendor 4	Project 2	11/1/20X6	317,273.52	x		x	x	x			x		x
Service vendor 4	Project 2	11/21/20X6	41,997.20	x		x	x	x			x		x
Service vendor 4	Project 2	12/13/20X6	183,350.25	x		x	x	x			x		x
Service vendor 4	Project 2	12/30/20X6	10,747.50	x		x	x	x			x		x

Vendor Name	Description	County paid date	Amount	IC (A)	IC (B)	Comp (C)	IC (D)	Comp (E)	IC (F)	Comp (G)	IC (H)	IC (I)	Comp (J)
Service vendor 5	Project 2	1/20/20X7	183,060.00	x		x	x	x			x		x
Service vendor 6	Project 3	2/9/20X7	325,565.40	x		x	x	x			x		x
Service vendor 6	Project 3	3/1/20X7	407,335.50	x		x	x	x			x		x
Service vendor 7	Project 3	3/21/20X7	662,838.00	x		x	x	x			x		x
Service vendor 8	Project 3	3/23/20X7	179,711.00	x		x	x	x			x		x
Service vendor 9	Project 4	4/10/20X7	527,490.00	x		x	x	x			x		x
Service vendor 10	Project 5	4/17/20X7	182,352.00	x		x	x	x			x		x
Service vendor 11	Project 6	5/20/20X7	61,350.00	x		x	x	x			x		x
Service vendor 11	Project 6	5/21/20X7	695,317.00	x		x	x	x			x		x
Employee 1	Payroll - Admin	7/14/20X6	2,257.65	x		x			x	x	x		x
Employee 2	Payroll - Admin	9/4/20X6	2,657.65	x		x			x	x	x		x
Employee 3	Payroll - Project 2	10/1/20X6	1,857.45	x		x			x	x	x		x
Employee 4	Payroll - Project 3	12/5/20X6	1,921.12	x		x			x	x	x		x
Employee 6	Payroll - Project 5	2/22/20X7	1,798.44	x		x			x	x	x		x
Employee 8	Payroll - Project 7	3/27/20X7	1,243.23	x		x			x	x	x		x
Employee 9	Payroll - Project 8	5/10/20X7	1,456.67	x		x			x	x	x		x
October 20X6					x							x	
December 20X6					x							x	
March 20X7					x							x	
June 20X7					x							x	

#### Tickmark Legend

IC Internal control test

C Compliance test

x Procedures completed without exception

(A) Allowable activities - internal control test - Looking for approval of Joe Client, County's CDBG Program Manager, and Jane Woodall, County's Grant Accounting Manager, prior to payment. Audit firm vouched documentation of approval without exception.

(B) Allowable activities - internal control test - Looking for documentation of review of monthly budget to actual results for the grant program reviewed by Jane Woodall, Grant Accounting Manager. Audit team noted review of statement without exception.

(C) Allowable activities - compliance test - Audit Firm reviewed expenditure noting apparent compliance of the activity with grant requirements and the county's Consolidated Action Plan.

(D) Allowable costs - internal control test - Looking for approval of Joe Client, County's CDBG Program Manager, and Jane Woodall, County's Grant Accounting Manager, prior to payment. Audit firm vouched documentation of approval without exception.

(E) Allowable costs - compliance test - Audit Firm reviewed expenditure noting apparent allowability of costs. This was evidenced by appropriate documentation following the applicable regulatory guidance.

(F) Allowable costs - internal control test - Looking for approval of Joe Client, County's CDBG Program Manager, and Jane Woodall, County's Grant Accounting Manager, of personnel expenditures prior to payment. Audit firm vouched documentation of approval without exception.

(G) Allowable costs - compliance test - Audit Firm reviewed expenditure noting apparent allowability of costs. This was evidenced by appropriate documentation for personnel expenditures under applicable regulatory guidance.

(H) Earmarking - internal control test - Looking for approval of Joe Client, County's CDBG Program Manager, and Jane Woodall, County's Grant Accounting Manager, prior to payment and entry to the general ledger. Audit firm vouched documentation of approval without exception.

(I) Earmarking - internal control test - Looking for documentation of review of monthly budget to actual results, which included the administrative earmarking calculation, for the grant program reviewed by Jane Woodall, Grant Accounting Manager.

(J) Earmarking - compliance test - Audit Firm noted that the expenditures were properly grouped in the general ledger according to program/function to allow for proper earmarking testwork performed at working paper (###).

#### Conclusion

The controls over the allowable activities and allowable costs requirements appear to be in place, and the county appears to be in compliance with the allowable activities and allowable costs requirements for the CDBG program. The controls over the Earmarking, Level of Effort, and Matching requirements appear to be in place and (when considered in conjunction with testwork at working paper ###), the county appears to be in compliance with the earmarking compliance requirements for the CDBG program.





## Chapter 3

# Types of Working Papers

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### Learning objectives

After completing this chapter you will be able to do the following:

- Identify the general types of working papers.
  - Recognize when to use the different types of working papers.
- 

### Introduction

Working papers consist of anything the auditor uses to document the results of his or her examination and the scope of his or her procedures. They also show how the client's financial records agree, or reconcile, to the financial statements reported on.

This chapter examines the types of working papers independent auditors use to document their work.

# Working paper flow

Working papers generally include the following:

- Draft of the financial statements and the auditor's report
- Trial balance and any adjustments and reclassification entries
- Audit program
- Documentation of the understanding of the client and its internal control, including tests of controls
- Notes, memorandums, copies or abstracts of minutes of meetings, contracts, and related documents
- Schedules that support the amounts that make up the financial statements

Working paper files generally present schedules that show the most summarized information in the front; the working papers generally show more detail the farther back they are in the files. The working papers generally present a logical flow of information that shows the financial statements, how they were created, and all the testing that was done on the financial statement components.

The most aggregated data, the financial statements, are generally filed in the front of the working papers; slightly more detailed data, such as the trial balance, would be filed after the financial statements but before the least aggregated schedules – the working papers showing tests of individual accounts or classes of transactions. Working papers on topics that affect the entire audit, such as planning memos, are also generally placed towards the front of working paper files.

# Primary detail schedules

Primary detail schedules are analyses of individual general ledger accounts.

Depending on the type and complexity of the account being analyzed, the general form will consist of one or more of the following:

- Analysis schedule
- Recalculation of computation schedule
- Comparison schedule
- Reconciliation schedule

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## Analysis schedule

An analysis schedule shows the activity in an account, such as additions and deletions, for the period under audit. Analysis schedules lend themselves to balance sheet accounts, such as investments, property and equipment, accruals, long-term debt, and equity accounts. Exhibit 3-1 shows an analysis schedule for property, plant, and equipment, which lists additions to machinery. On such a working paper, the auditors commonly would document tests they perform, such as recalculation, tracing to the lead schedule, and vouching of back-up documentation.



**Exhibit 3-1<sup>1</sup> Property, plant, and equipment – machinery additions**

				Prepared by	PBC
				Date	
Date	Vendor	Description	Estimated life	New or used	Cost
3/12/x	Webster Supply	Forklift	5	N	9,874.53
9/10/x	Central Ford	Pick-up truck	3	N	14,797.84

---

## Recalculation of computation schedule

This type of schedule shows the basis for the amounts that make up the balance in an account. It is most effective when detailed vouching of payments is not considered important and for reasonableness tests. For example, to support the analysis of interest expense, a working paper could show the

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calculation of the amount of the average loan balance for the year multiplied by the interest rate. (A list of monthly interest payments would be another way to calculate the total interest expense – a working paper showing that would be an *analysis schedule*.) Also, the tests of payroll taxes could indicate the calculation of taxable wages multiplied by the applicable rate.

## Comparison schedule

A comparison schedule shows the details of account balances for the current year and prior year. Comparisons form the basis for many analytical procedures. Exhibit 3-2 presents a typical lead schedule for cash. Notice that this working paper shows current and prior year balances for each general ledger account that is included in the cash total. Comparison schedules are often part of the lead schedule.



**Exhibit 3-2<sup>2</sup> Cash lead schedule**

									Prepared by	
									Date	
				Adjustments				Reclassifications		
Working paper reference	Account	Description	Final prior year	Per ledger this year	Dr.	Cr.	Adjusted this year	Dr.	Cr.	Final this year
	1010	Petty Cash	300.00	300.00			300.00			300.00
	1050	Checking Account	33,601.46	12,469.85			12,469.85			12,469.85
	1060	Savings Account		712.20			712.20			712.20
			33,901.46	13,482.05			13,482.05			13,482.05

## Reconciliation schedule

A reconciliation schedule shows support for an account balance by reference to a detailed schedule or subsidiary ledger. Examples include cash reconciliation and accounts payable and receivable control accounts. Exhibit 3-3 presents a bank reconciliation. The list of the reconciling items allows auditors to pinpoint easily those items they may wish to test further. At a minimum, auditors would probably foot the schedule and trace the balance per books to the lead schedule.

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### Exhibit 3-3<sup>3</sup> Bank reconciliation

		Prepared by	PBC
		Date	
Balance per bank			22,386.22
Deposits in transit	12/31/x	1,530.00	23,916.22
Bank error	12/15/x	64.00	23,980.22
Deduct:			
Outstanding Checks		6,510.37	17,469.85
Other reconciling items (describe)			
Wire transfer	12/31/x	5,000.00	12,469.85
Balance per books before adjustment			12,499.85
Adjustments (identify and describe)			
Bank service charges	12/31/x	25.00	12,474.85
Bank charge for returned checks	12/31/x	5.00	12,469.85

## Knowledge check

1. Which of the following is likely to be a primary detail schedule?
  - a. Analysis schedule.
  - b. Trial balance.
  - c. Grouping (or lead) schedule.
  - d. A copy of a cancelled check.

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# Lead schedules

Lead schedules summarize similar or related accounts appearing as a line item in a financial statement. They summarize the primary detail schedules, as shown in exhibit 3-2. For example, the balance sheet caption for cash might consist of the total of the applicable trial balance accounts of

- Petty cash;
- Regular checking accounts;
- Payroll imprest accounts; or
- Cash equivalents, such as treasury bills.

Frequently, a single general ledger account balance, such as goodwill, is not combined with other accounts for financial statement presentation. In those cases, the primary detail schedule may also serve as the lead schedule.

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## Financial statement assembly schedules

Financial statement assembly schedules summarize the information on the lead schedules in financial statement or report format. Assembly schedules usually show the final balances for the preceding year, the ending balance for the year, and any current year adjustments or reclassifications.

Instead of preparing assembly sheets, many practitioners tie the primary detail schedules or lead schedules directly to a working trial balance. This alternative is most useful if the client's general ledger accounts are in a sequence that allows easy grouping into financial statement classifications. Practitioners who use this method believe that the preparation time saved and elimination of duplicated information justifies its use.

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## Knowledge check

2. The primary purpose of lead schedules is to
  - a. Provide a basis for testing accounts.
  - b. Group related accounts.
  - c. Describe the planned level of substantive procedures.
  - d. Provides evidential support for an account balance or class of transactions.

# Trial balance

The trial balance is a list of the account balances in the general ledger. At a minimum, it should contain the account number, title, and balance for each account as of the balance sheet date and for the prior year.

If assembly sheets are *not* prepared, the working trial balance should also tie directly to the primary or lead schedules. The working trial balance should also reflect any adjustments or reclassifications made to the accounts. This working paper is usually at or near the front of the current file.

Exhibit 3-4 presents a typical working trial balance. Notice that it presents a useful summary of prior year and current year balances, adjustments and reclassifications, and it has a handy working paper reference column. The reference might be used by the reviewer to locate additional detail quickly. The final balances in the right-hand column are grouped on the financial statements to provide a roadmap from the financial statements to individual working papers.



### Exhibit 3-4<sup>4</sup> Working trial balance – assets

							Prepared by	
							Date	
				Adjustments			Reclassification	
Working paper reference	Description	Final prior year	Per ledger this year	Dr.	Cr.	Adjusted this year	Dr.	Cr.
	Cash	33,901.46	13,482.05			13,482.05		
	Notes receivable						12,000.00	
	Less allowance							
	Trade Accounts Receivable	363,317.81	505,362.76			505,362.76		
	Less allowance for doubtful accounts	(12,000.00)	(11,924.03)	1,353.11	4,429.08	(15,000.00)		
	Net	351,317.81	493,438.73	1,353.11	4,429.08	490,362.76		
	Accounts receivable – related parties							
	– other	71,075.38	55,329.60			55,329.60		
	Income tax refundable	12,877.73						
	Inventories:							
	Merchandise							
	Finished Goods							
	Work in process							
	Raw materials							
	Total	497,857.54	422,231.18			422,231.18		
	Prepaid expenses	2,219.48	1,303.00			1,303.00		
	Investments							
	Fixed Assets							
	Land	5,076.00	5,076.00			5,076.00		
	Buildings	89,523.97	89,523.97			89,523.97		
	Leasehold improvements							

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### Exhibit 3-4 Working trial balance – assets (continued)

							Prepared by		
							Date		
				Adjustments		Reclassification			
Working paper reference	Description	Final prior year	Per ledger this year	Dr.	Cr.	Adjusted this year	Dr.	Cr.	Final this year
	Machinery and equipment	61,214.77	85,887.14			85,887.14			85,887.14
	Furniture and fixtures	10,641.58	6,496.75			6,496.75			6,496.75
	Total	166,456.32	186,983.86			186,983.86			186,983.86
	Less accumulated depreciation and amortization	(76,098.62)	(108,487.43)			(108,487.43)			(108,487.43)
	Net	90,359.70	78,496.43			78,496.43			78,496.43
	Capitalized Leased Assets								
	Notes receivable	48,700.00	36,700.00			36,700.00		12,000	24,700.00
	Other assets	5,835.75	5,821.54			5,821.54			5,821.54

# Tickmark legend

Near the front of the file, or sometimes at the beginning of each folder, auditors commonly place a master "tickmark legend." Alternatively, tickmarks can be explained on each working paper. Frequently, firms combine the two approaches: a set of tickmarks for common types of procedures used across the audit and specific tickmarks used for particular tests shown on the relevant working paper. Exhibit 3-5 illustrates a tickmark legend.



**Exhibit 3-5 Explanation of standard tickmarks**

Mark	Explanation
F	Footed
CF	Crossfooted
Ç	Calculation checked and agreed
PY	Agreed to prior-year working papers
TB	Traced to trial balance
GL	Traced to general ledger
R	Agreed to report
C	Confirmed
T	Traced to [describe source]

# Adjustments and reclassifications

*Adjusting journal entries* are adjustments to correct misstatements found by the auditor during the audit. For example, a material write-down of inventory may be deemed necessary due to auditor findings after the client has closed its books. See exhibit 3-6.

Before an adjustment is proposed, it should be thoroughly documented.

Adjusting journal entries proposed by the auditor generally are identified as either posted to the client's books or waived.



## Exhibit 3-6 Sample adjusting journal entry working paper

### ABC Co. Adjusting Journal Entries 12/31/X3

W.P. Ref.			Client's Acct. No.	Dr.	Cr.
	1				
D-1		Provision for doubtful accounts	610	2,500 P	
		Allowance for doubtful accounts	135		2,500 P

To provide an allowance for the balance of 2,500 due from Zxy Industries, which disclosed its intent to file under chapter 11 on 12/27/X3.

	2				
E-3		Cost of sales	550	200 W	
		Inventory – supplies	145		200 W

To adjust supplies inventory at Plant B to 6,500 per the 12/31/X3 physical.

P = Traced to client's posting of general ledger.

W = Waived; immaterial.

*Notes.* Adjustments affect the client's accounts and are the client's entries. Their explanations should offer a reader enough information to know why the entry is needed. To merely say "adjust balance to actual" or "per Working paper E-3" is not enough.

There are separate requirements for waived adjustments. They should be summarized and analyzed in a form similar to exhibit 3-7.

The auditor is required to aggregate all immaterial adjustments proposed by the auditor but not posted to the client's books to ensure that, taken together, they are still not material. The auditor is required to document

- The summary of uncorrected misstatements, showing known and likely misstatements and the effect of uncorrected misstatements from prior periods;
- The auditor's conclusion about whether they materially misstate the financial statements;
- The basis for that conclusion; and
- Misstatements identified by the auditor that were corrected by the client.

To illustrate, in Exhibit 3-7, the auditor need not accumulate misstatements less than \$250, which are clearly immaterial. However, the auditor should document any misstatement amounts above \$250.

Exhibit 3-7 illustrates a summary of uncorrected misstatements.



### Exhibit 3-7 Aggregation of identified misstatements\* (Amounts below \$250 considered clearly trivial)

Description	Current assets	LT assets	Current liabilities	LT liabilities	Equity	Revenue	Expense
<b>Factual misstatements:</b>							
Dr. Cash	4,000						
Cr. Accounts Payable			(4,000)				
<i>entry to properly reclass overdraft amounts from "negative cash" to accounts payable. See testing at working paper A-1*--BOOKED</i>							
Dr. Electric Expense							1,000
Cr. Accounts Payable			(1,000)				
<i>entry to properly accrue for December electric costs. See testing at working paper E-5**</i>							
<b>Judgmental misstatements:</b>							
Dr. R&M Reserve				1,000			
Cr. Inventory production cost							(1,000)
<i>entry to reduce repair and maintenance reserve to expected value. See analysis performed at working paper I-8*</i>							



### Exhibit 3-7 Aggregation of identified misstatements\* (Amounts below \$250 considered clearly trivial) (continued)

Description	Current assets	LT assets	Current liabilities	LT liabilities	Equity	Revenue	Expense
Total misstatements identified	4,000		(5,000)	1,000			0
Effect in current year of prior-year unadjusted items			(1,500)				3,500
Total adjustment	4,000		(6,500)	1,000	2,500		3,500
Less: adjustments booked	(4,000)		4,000				
Uncorrected misstatements	0		(2,500)	1,000	2,500		3,500
Amount reported in unadjusted financial statements	521,561	251,051	(448,151)	(258,415)	(66,046)	(236,594)	568,958
Effect of misstatement (%)**	0%	0%	0.56%	(.038%)	(3.79%)	0%	0.62%

\* Working paper references are noted for illustrative purposes only.

\*\* It should be noted that a typical audit does not result in enough testing to opine on an account (or group of accounts) level balance. Therefore, this percentage by account classification is for informational use only by the auditor in determining the effects of unadjusted audit entries on the financial statements as a whole.

## Knowledge check

3. The summary of adjusting journal entries
  - a. Should contain only those entries actually made to the financial statements.
  - b. Should contain all entries proposed, whether waived or not.
  - c. Should only contain entries considered to be material.
  - d. Should contain the supporting analysis.

# Revenue and expense working papers

Working papers on revenue and expense accounts include comparative lead sheets for each income statement classification. Expenses, such as depreciation, insurance, interest, and the provision for doubtful accounts, are cross-referenced to related analyses included among the working papers for the balance sheet classifications.

The auditor, after considering his or her assessment of risk, including internal control, may decide that analytical procedures and substantive tests of balance sheet accounts (including related income and expense accounts) provide enough evidence to avoid the need for detailed analysis of most individual revenue and expense accounts. Some revenue and expense accounts, however, are ordinarily analyzed and tested because of the following:

- Identification of possible disclosure matters (for example, analysis of lawyers' billings might indicate potential contingencies)
- Information needed for preparing tax returns and other reports
- Potential misclassifications and errors

The following accounts are generally analyzed separately:

- Legal expenses and other professional fees
- Maintenance and repairs
- Travel and entertainment
- Officers' salaries and expenses
- Taxes, licenses, and fees
- Rents and royalties
- Contributions
- Advertising

For timesaving purposes, the auditor may request the client to prepare analyses of these accounts and to assemble the related vouchers and other supporting documents.

# Dual-purpose working papers

Through clever planning the auditor can design working papers that provide a summary of the composition of an account balance, the scope of work performed, and data needed to prepare financial statement disclosures. See exhibits 3-8 and 3-9.



## Exhibit 3-8 Analysis of fixed assets

Description	Beginning balances	Additions	Dispositions retirements	Ending balances
Production equipment (Leon's)	\$982,892.96	\$90,177.54	\$0.00	\$1,073,070.50
Production equipment (Woody's)	154,118.07	0.00	0.00	154,118.07
	1,137,011.03	90,177.54	\$0.00	1,227,188.57
Transportation equip. (Leon's)	97,165.85	3,250.00	0.00	100,415.85
Transportation equip. (Woody's)	4,100.00	0.00	0.00	4,100.00
	101,265.85	3,250.00	\$0.00	104,515.85
Leasehold improvements (Leon's)	108,117.84	1,520.00	0.00	109,637.84
	1,346,394.72	94,947.54	0.00	1,441,342.26
Accumulated depreciation (Leon's)	(799,112.00)	(76,680.00)	0.00	(875,792.00)
Accumulated depreciation (Woody's)	(80,322.00)	(7,686.00)	0.00	(88,008.00)
	(879,434.00)	(84,366.00)	0.00	(963,800.00)
Net property, plant and equipment	\$466,960.72	\$10,581.54	\$0.00	\$ 477,542.26
<b><u>General Notes</u></b>		<b><u>Specific Comments</u></b>		
1. Per review of schedule, no unusual items were noted. 2. See working paper JJ for test of repairs expense for items that should have been capitalized. 3. Test of reasonableness of depreciation expense:		1. Fully depreciated assets equal \$564,324. 2. The shareholder leases the building to the company. See RR for rent test and disclosure. 3. Vouching test – fixed asset additions. Scope: All over \$12,000		
Average PP&E outstanding	\$1,393,868	Machine #1 Machine #2 Machine #3	\$19,000 \$19,000 \$19,000	
Depreciation expense	\$ 84,366	Test Coverage = \$57,000 is 60% of total additions for the year – sufficient		
Est. average life of assets	16 years	4. Estimated lives of assets: Machinery 20 years Furniture & Fixtures 12 years Vehicles 5 years		



### Exhibit 3-8 Analysis of fixed assets (continued)

Exhibit 3-8 accomplishes the following:

- Captures amounts needed for the cash flow statement
  - Depreciation expense
  - Net book values of assets retired or otherwise disposed of during the year
  - Purchases and acquisitions of fixed assets during the year
- Documents procedures performed
  - General note mentioning the review of the schedule for unusual items
  - Vouching test of purchased items
  - Reasonableness test of depreciation expense
  - Reference to working paper where test for capital items that might have been expensed
- Provides a "big picture" overview of activity in a significant class of transactions from the financial statement viewpoint
- Provides supporting documentation for footnote disclosures (for example, estimated useful lives and fully depreciated assets still in service)
- Facilitates review of key engagement issues, including relative importance of fixed assets by operating facility or location or division





## Exhibit 3-9 Analysis of indebtedness

Exhibit 3-9 Analysis of Indebtedness												
Description	Balances Prior Yr.	Borrow	Repay	Balance Cur. Yr.	Matures X1	Matures X2	Matures X3	Matures X4	Matures X5	Accrued Int. Beg. Of Year	Provisions to Expenses	Accrued Int. End of Year
American Mortgage P Monthly payment of \$2,288 including interest at 10.6%, due August 1995, secured by land and building.	\$200,663.98	\$0.00	\$6,397.54	\$194,266.44	\$7,050.37	\$7,838.74	\$8,715.30	\$170,662.03	\$0.00	\$0.00	\$21,058.46	\$21,058.46
Gainesville National Bank P Monthly payments of \$1,369 including interest at 11.58% due December 1992, secured by land and building.	110,601.55	0.00	4,652.70	105,948.85	105,948.85	0.00	0.00	0.00	0.00	0.00	11,775.30	11,775.30
Elizabeth A. Clark P Payable in weekly installments of \$154 including interest at 8.5% over the less or of life or retirement of note.	33,440.25	0.00	29,279.25	4,161.00	4,161.00	0.00	0.00	0.00	0.00	0.00	3,847.00	3,847.00
Bank One P Monthly installments of \$600 including interest at 10.8%, due April 1994, secured by vehicles.	17,987.00	0.00	5,529.08	12,457.92	6,157.00	6,300.92	0.00	0.00	0.00	0.00	1,670.92	1,670.92
Bank One P Monthly installments of \$300 including interest at 13.4%, due April 1994, secured by forklifts.	9,014.09	0.00	2,762.48	6,251.61	3,078.00	3,175.61	0.00	0.00	0.00	0.00	837.52	837.52
Bank One, Installment Note	343.75	0.00	343.75	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	\$372,050.62	\$0.00	\$48,964.80	\$323,085.82	\$126,393.22	\$17,315.27	\$8,715.30	\$170,662.03	\$0.00	\$0.00	\$39,189.20	\$39,189.20

Auditor's Notes	
1. Payments and maturities were traced to amortization schedules.	Debt, beg of year \$372,050.62
2. Per review of schedule, no unusual items were noted.	Debt, end of year \$323,085.82
3. Source of data: Copies of notes.	Average Debt O/S \$347,568.22
4. See work paper XX for loan compliance tests.	Interest Expense \$39,189.20
	Est. Interest Rate 11.28%



### Exhibit 3-9 Analysis of indebtedness (continued)

Exhibit 3-9 accomplishes the following:

- Captures information needed for the cash flow statement
  - Borrowings and repayments, which are to be reported gross, not net
  - Interest payments, on a cash basis
- Summarizes information required to be disclosed in the financial statements or footnotes:
  - Interest expense
  - Five year maturities
  - Repayment terms, maturities, covenants, collateral, and so on
- Facilitates overall review, can see the “big picture”
- Documents the procedures performed
  - Reasonableness test of interest expense
  - Review for unusual items
  - Indicates the source of data, that is, amortization schedules and executed copies of note instruments
- Indicates cross-reference to working paper where compliance with loan covenants is documented

# What all of these working papers show

All of the working papers should clearly indicate the following:

- The client's name
- The title of the working paper or a description of its contents
- The audit period covered or the balance sheet date
- Who prepared the working paper, when it was prepared, and who reviewed it and when
- Any adjustments or reclassifications made
- Proper index reference

The working papers should be sufficient to enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures, and the evidence obtained.

When the auditor uses analyses or schedules that are prepared by the client, the auditor should include a notation on the working paper such as "Prepared by client" (PBC) and indicate the name of the auditor who tested it.

# Summary

There are five general types of working papers:

1. Primary detail schedules
2. Lead schedules
3. Financial statement assembly schedules
4. Trial balances
5. Adjustments and reclassification schedules



## Chapter 4

# Documenting Audit Tests

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### Learning objectives

After completing this chapter, you should be able to do the following:

- Analyze how risks, audit procedures, and audit evidence are linked.
- Determine documentation requirements for the following:
  - An understanding of internal control;
  - Tests of details; and
  - Analytical procedures.

# Audit evidence

The auditor links the assertions to the procedures applied to demonstrate that all relevant assertions have been tested and the auditor has obtained sufficient evidence about them. Some auditors create objectives as a middle ground between the procedures to the assertions.

The working papers often link the risks identified to the related procedure applied to obtain evidence. The working papers show

- the assessment of risks at the assertion level and the bases for the assessment;
- the objectives of the tests of controls or substantive procedures;
- a description of the tests applied; and
- documentation of the actual tests and the results.

Some firms create matrix forms documenting the risk assessment by account and by assertion, showing the specific procedures designed to address each risk. Exhibit 4-1 illustrates such a linkage.



## Exhibit 4-1 Linkage of risks and audit procedures

### Inventory

Account:	Inventory				
Assertion	Risk	Basis	Objective	Procedure	W/P Ref.
Valuation	Risk of obsolete inventory	Inventory amts disproportionately higher than last year. Inventory subject to quick obsolescence	Slow-moving, excess, defective inventories are properly identified	<ul style="list-style-type: none"><li>▪ Examine an analysis of inventory and obsolete items included in turnover.</li><li>▪ Analyze industry experience and trends.</li><li>▪ Analytically compare the relationship of inventory balances to anticipated sales volume.</li><li>▪ Walk-through the plant for indications of products not being used.</li><li>▪ Inquire of production and sales personnel concerning possible excess, or defective or obsolete inventory items.</li><li>▪ Analytically compare volumes of returns with previous years.</li></ul>	



#### Exhibit 4-1 Linkage of risks and audit procedures (continued)

Account:	Inventory				
Assertion	Risk	Basis	Objective	Procedure	W/P Ref.
			Inventories are reduced, when appropriate, to replacement cost or net realizable value	<ul style="list-style-type: none"><li>▪ Inspect sales catalogs or industry publications for current market value quotations.</li><li>▪ Recalculate inventory valuation reserves.</li><li>▪ Analyze current production costs.</li><li>▪ Examine sales after year end and open purchase order commitments.</li></ul>	



# Documenting risk assessment and internal control

The auditor's understanding of the entity and its environment provides the context in which risks can be assessed. To understand what can be misstated, the auditor needs to understand the entity's operations and pressures it operates under.

The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Selection and application of accounting policies, including the reasons for changes thereto
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance

Documentation of this understanding should include the following:

- Key elements of the understanding of each of the five aspects discussed above
- The sources of information from which the understanding was obtained
- The procedures applied to obtain the understanding

# Documenting the understanding of the entity and its environment, including internal control

The auditor is required to obtain and document the understanding of the client's entity and its environment, including internal control relevant to the audit and audit planning. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the client's internal control:

- A very large or complex company may have its own documentation of internal control that the auditor can photocopy and put in the working papers.
- For a medium-sized company, the auditor might document the understanding by using flowcharts or questionnaires.
- For a small company, memorandums and checklists may be sufficient.

Generally, the more complex the internal controls and the more extensive the procedures the auditor performs, the more extensive the auditor's documentation should be. Auditors should note that regardless of the size and complexity of the entity, paragraph 14 of AU-C section 315 requires that when obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel.

If the auditor has previous experience with the client, which is to say that the client's controls are documented adequately in the auditor's prior year working papers, he or she can significantly reduce the work needed to understand internal control. In that case, the auditor can focus his or her efforts on identifying changes in controls implemented since the prior year.

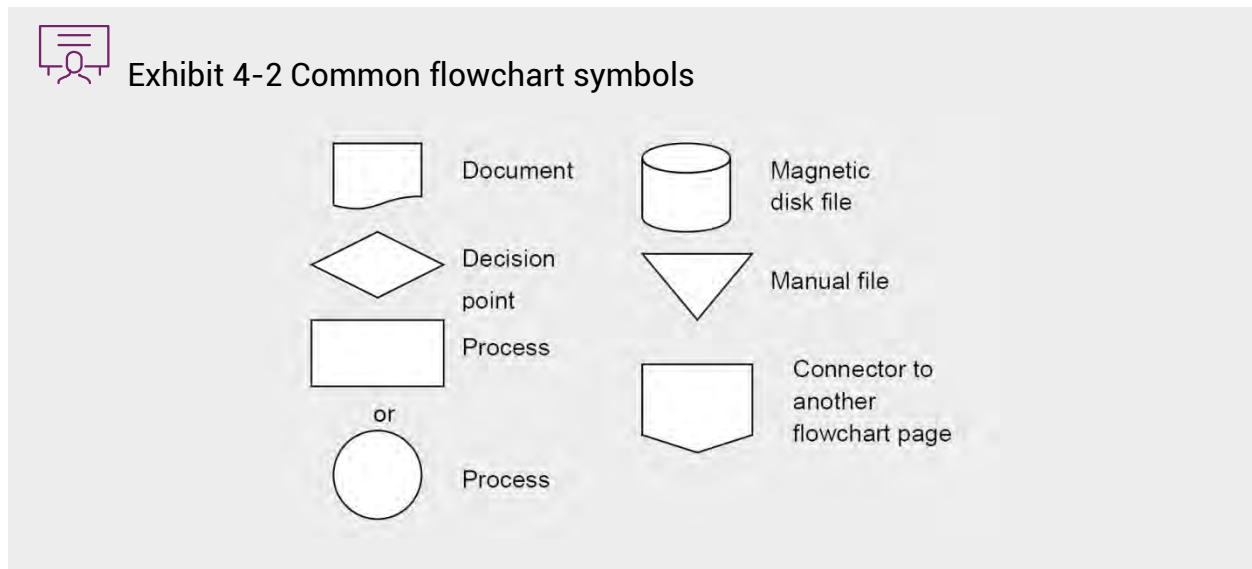
The requirement to document the understanding of controls applies to all audits regardless of whether the auditor decides to test controls to reduce the level of substantive procedures.

The control environment is usually documented on a companywide basis (or, if there are several locations with different control environments, for each such location), because those controls generally affect most or all account balances or classes of transactions. Risk assessment and monitoring may be documented on a cycle, account, or class basis; however, in many clients, particularly small client audits, these controls are so informal that it is more efficient to document them on an entity-level basis. The control activities and information and communication system, on the other hand, are commonly documented by cycle, account, or class of transaction depending on the firm's audit approach or the strategy used on the individual audit.

The most common documentation methods are memorandums, flowcharts, and questionnaires:

- *Memorandums* are narrative descriptions of the relevant controls.
  - They are most useful when the matter being described is relatively simple or linear.
  - Memorandums become less useful when there are complex interrelationships between components being described because, in those cases, showing the interrelationships graphically can often be more effective than merely describing them.
- *Flowcharts* may be more useful when the controls become more complex.
  - A flowchart is a graphic depiction of operations and decisions applied in the company's internal control.
  - Flowcharts need not be elaborate to be effective; their primary advantage is that complex matters can often be made easier to understand by showing them graphically than by describing them.

Exhibit 4-2 illustrates common flowcharting symbols.



- *Checklists and questionnaires* are also common methods of documenting the understanding.
  - They are especially useful when there are specific items or procedures that the auditor wants to focus on or the auditor wants to ensure that all relevant matters have been considered.
  - The information in checklists and questionnaires is generally easier to summarize than the information in memos and flowcharts.

There are two general types of internal control questionnaires:

1. *Open-ended questionnaires* – Ask general questions and let the auditor document whatever information is relevant. These questionnaires are becoming the prevalent method of documenting internal control.
2. *Closed-ended questionnaires* – Ask questions that must be answered “yes” or “no.” They typically are helpful in assessing design effectiveness. It will never be sufficient to document internal control solely through closed-end questionnaires because they cannot describe all the elements required in the understanding.

The closed-ended questionnaires are comprehensive and can be useful with large clients. However, they are less flexible and many of the questions are not applicable to small clients. Therefore, for your small clients, you may want to consider the open-ended questionnaire.

These documentation methods are illustrated in exhibits 4-3–4-6. They are included to demonstrate different approaches to document the same information. They do not purport to include all the information required by AU-C section 315.



### **Exhibit 4-3 A Memorandum documenting the understanding of the client's internal control**

Watson Electronics, Inc.  
Sales Cycle

Sales representatives make all sales and when an order is received they fill out a sales order (see exhibit on page R-2<sup>1</sup>), which is a four-page form. The sales rep fills out all of the information on the sales order. Sales prices are taken from the master price list; if a different price is used, the sales rep provides a written explanation of the price variance.

The completed sales order is sent to Jack Watson, President, for his review. If he approves the price and credit terms, he signs the sales order and sends one copy to shipping and one to the bookkeeper. The other two copies, which are not relevant to internal control are sent to the customer and sales rep.

In shipping, the warehouseman, after seeing that Jack Watson has approved the sales order, has the merchandise pulled from storage and has a shipping request (see exhibit on page R-31) prepared. A shipping clerk compares the goods pulled for shipment to the sales order and shipping report and if they all agree, he initials the shipping report and ships the goods. Then he sends a copy of the shipping report to the bookkeeper and sends another copy to the customer and files the third.

The bookkeeper matches the shipping report to this sales order previously received and enters the stock number, quantity, sales price, and customer number into the microcomputer. The computer prints the invoice, which is sent to the customer, and a copy is filed along with the sales order and shipping report. Monthly, the bookkeeper investigates unmatched sales orders and shipping reports.

Daily, the invoice information updates the sales and accounts receivable files. The sales file produces the shipping and sales reports, which Jack Watson reviews weekly. The sales file is used to produce the semimonthly aged trial balance, which Watson reviews and he follows up on delinquent accounts. It also serves as the source for customer statements and the general ledger, which are both produced monthly.

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<sup>1</sup> Not reproduced in this illustration.



Exhibit 4-4 A Flowchart documenting Watson Electronics' sales cycle

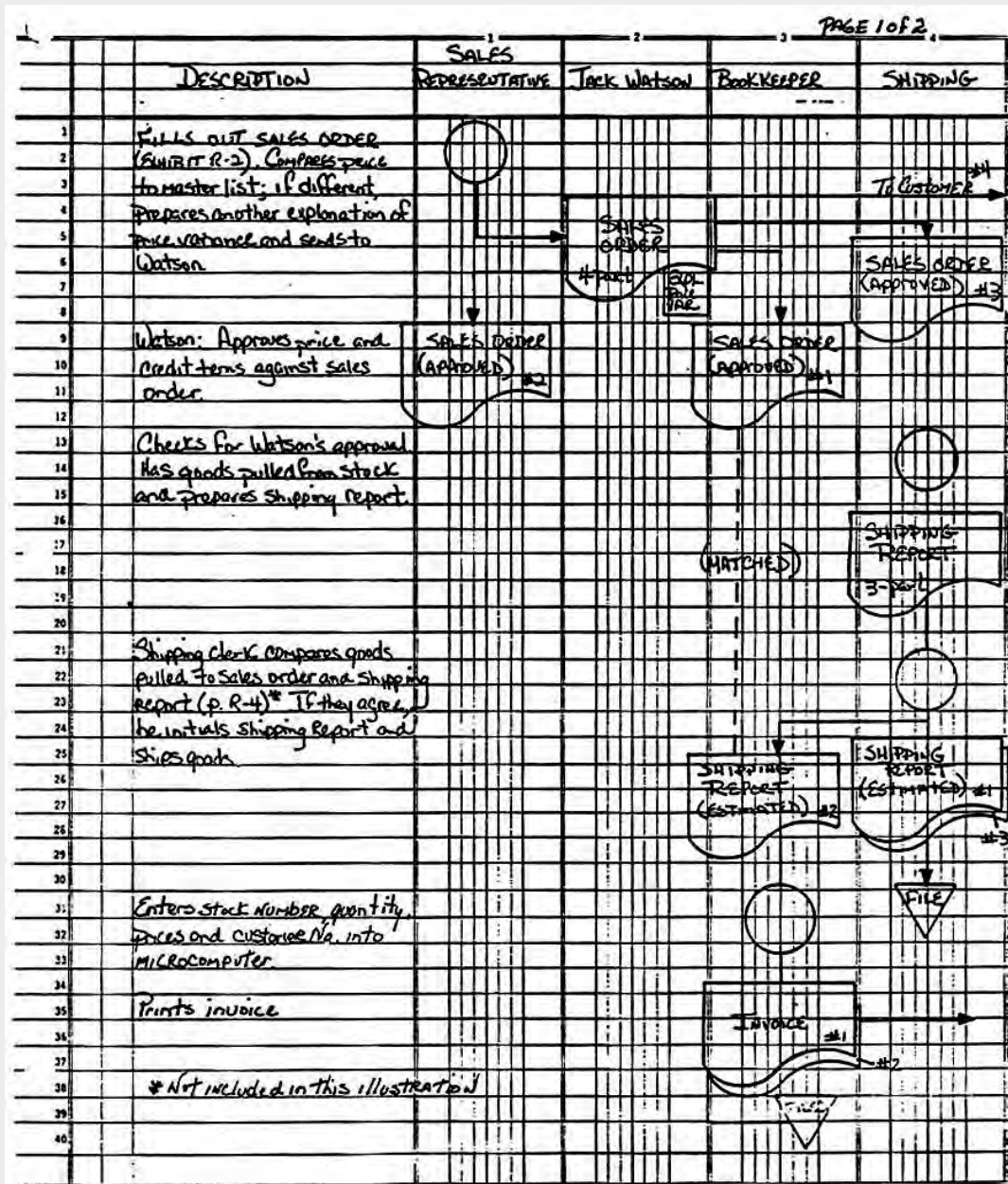






Exhibit 4-4 A Flowchart documenting Watson Electronics' sales cycle (continued)

WATSON ELECTRONICS		Date	Prepared By	Work Paper No.
SALES CYCLE			Reviewed By	
		PAGE 2 of 2		
		JACK WATSON BOOKKEEPER		
1				
2	INVOICE UPDATES ACCOUNTS			
3	RECEIVABLE AND SALES FILE			
4	ONLY.			
5				
6				
7				
8				
9				
10	SALES FILE PROVIDES SALES AND			
11	SHIPPING REPORT WEEKLY WHICH			
12	JACK WATSON REVIEWS.			
13				
14				
15				
16	ACCOUNTS RECEIVABLE FILE IS THE			
17	SOURCE FOR SEMI-MONTHLY AGED			
18	TRIAL BALANCE, WHICH JACK WATSON			
19	REVIEWS FOR DELINQUENT ACCOUNTS.			
20	MONTHLY GENERAL LEDGER AND			
21	MONTHLY CUSTOMER STATEMENTS.			
22				
23				
24				
25				
26				
27				
28				
29				
30				
31				
32				
33				
34				
35				
36				
37				
38				
39				
40				

Flowchart details:

- INVOICE UPDATES ACCOUNTS RECEIVABLE AND SALES FILE ONLY.
- SALES FILE PROVIDES SALES AND SHIPPING REPORT WEEKLY WHICH JACK WATSON REVIEWS.
- ACCOUNTS RECEIVABLE FILE IS THE SOURCE FOR SEMI-MONTHLY AGED TRIAL BALANCE, WHICH JACK WATSON REVIEWS FOR DELINQUENT ACCOUNTS. MONTHLY GENERAL LEDGER AND MONTHLY CUSTOMER STATEMENTS.
- SALES AND SHIPPING REPORT
- AGED TRIAL BALANCE
- GENERAL LEDGER
- MONTHLY STATEMENT TO CUSTOMER

Form 114C • HG Professional Forms • Omaha, Ne. 68102 DATE \_\_\_\_\_ W. P. No. \_\_\_\_\_



## Exhibit 4-5 Open-ended questionnaire for documenting

### The understanding of information and communication

Client Watson Electronic Balance sheet date 12/31/X1

Completed by AEC Date 10/29/X2 Reviewed by DEF Date 11/9/X2

Instructions: This questionnaire is used to document the understanding of the client's accounting system. The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report, the entity's transactions and to maintain accountability for the related assets and liabilities.

Fill in the relevant information called for below for each accounting system application. The information should be sufficient to document how the transaction is processed from initiation to inclusion in the financial statements. It is not necessary, however, to describe the processing or flow of documents that are not relevant to the accounting system (such as multiple copies of forms that are distributed outside of the accounting system).

Account or class of transactions Sales

How is the transaction initiated? Sales representatives take orders from customers and fill out a four-part sales order

Describe the relevant accounting records, supporting documents, machine-readable information, and specific accounts involved in the processing of transactions and how they are processed, including how the computer is used to process data. (Relevant control procedures may also be included in the description.)

Document Sales order (see exhibit, p. R-3<sup>2</sup>)

How is it processed and what does it generate? Sales rep. fills out sales order; if there is a difference between price master list and price quoted he explains variance in writing. Jack Watson approves price and credit terms and signs. Approved sales order is sent to bookkeeper (for later matching with shipping report), shipping, sales rep. and customer.

Document Shipping report (see exhibit, p. R-4<sup>3</sup>)

How is it processed and what does it generate? Completed by shipping dept. Reflects goods actually pulled from stock. Goods as pulled based on approved sales order (clerk checks for approval before goods are pulled). After shipping report is compared with sales order and goods pulled, the goods are shipped and shipping report is sent to bookkeeper. Other copies are sent to customer and filed in shipping.

<sup>2</sup> Not included in this illustration.

<sup>3</sup> Ibid.



#### Exhibit 4-5 Open-ended questionnaire for documenting (continued)

Document Invoice

How is it processed and what does it generate? Generated by computer based on sales order and shipping report information initiated by bookkeeper. A copy is sent to the customer and another is filed in accounting along with sales order and shipping report. Invoice date is used to update accounts receivable and sales files daily.

Document A/R subledger

How is it processed and what does it generate? Updated daily based on invoices. It is used to process semimonthly aged trial balance, which Jack Watson reviews for delinquent accounts. It is also used to produce monthly customer statements and general ledger (produced monthly).

Document Sales journal

How is it processed and what does it generate? Updated daily based on invoice. It is used to produce a weekly shipping and sales report, which is reviewed by Jack Watson.

Are any significant estimates or disclosures involved in this area? No

If so, describe the process used to develop them. Estimation of the allowance for doubtful accounts is done separately and discussed on p. D-17<sup>4</sup>



#### Exhibit 4-6 An Internal control questionnaire for control activities

II. Revenue Cycle (Revenue & Receivables)			
	Completed by ____		
	Answer		
	Yes	No	Comments
A. Revenue and Accounts Receivable			
1. Is credit approved by the owner or a designated credit manager?			
2. Are credit files maintained on a current basis for significant customers?			
3. Are commission rates set or approved by the owner?			

<sup>4</sup> Ibid.





#### Exhibit 4-6 An internal control questionnaire for control activities (continued)

	Completed by _____		
	Answer		
	Yes	No	Comments
4. Are sales orders or work orders approved by the owner or a responsible employee for			
a. Price?			
b. Terms of sale, including delivery dates?			
c. Credit?			
d. Account balance limits?			
5. Are all sales orders (or work orders) recorded on pre-numbered forms, and are all numbers accounted for?			
6. Are shipping documents			
a. Prepared for all shipments?			
b. Pre-numbered and all numbers accounted for?			
c. Based on approved sales orders and matched with sales invoices?			
d. Processed promptly?			
7. Are all sales invoices			
a. Pre-numbered and all numbers accounted for?			
b. Compared to shipping documents?			
c. Checked for price and terms?			
d. Checked for clerical accuracy?			
e. Recorded promptly?			
8. Are all credit memos pre-numbered and all			
a. Numbers accounted for?			
b. Approved			
c. Recorded promptly?			
9. Is there a proper cut-off of sales at month end?			



#### Exhibit 4-6 An internal control questionnaire for control activities (continued)

	Completed by ____		
	Answer		
	Yes	No	Comments
10. Are monthly statements of account for all trade receivables balances:			
a. Reviewed by the owner before mailing?			
b. Mailed by the owner or a responsible employee other than the bookkeeper?			
11. Is the accounts receivable subsidiary ledger balanced monthly to the general ledger control account?			
12. Is an aging schedule or schedule of past due customers' accounts prepared monthly?			
13. Does the owner or credit manager review monthly listings of past due customer accounts and investigate delinquent accounts and unusual items?			
14. Are write-offs and other adjustments to customers' accounts authorized by the owner?			

Auditors often use an open-ended checklist to summarize the effectiveness of internal control and its effect on the audit strategy. Exhibit 4-7 illustrates such a summary.



## Exhibit 4-7 Evaluation of entity-level controls 389

### Information and communication

Points to Consider:

- Obtaining external and internal information and providing timely and adequate reports on the entity's performance to management
- Management's support for the development and maintenance of an information system (both human and financial)
- Establishment of external and internal channels of communication
- Adequacy of communication across the organization and the completeness and timeliness of information
- Monitoring and compliance requirements imposed by legislative or regulatory bodies, or by others outside the entity (such as an active review of bank loan agreements)<sup>5</sup>

### Relevant control objectives, risks, and features

Control objectives	Risks of failure to achieve the objective	Indications that the control objective is not being met	Implemented control features	Control design?	Ref.
Individuals involved in the financial reporting process understand their roles and responsibilities.	<ul style="list-style-type: none"> <li>▪ Inaccurate accounting records</li> <li>▪ Failure to capture, record, and process all transactions and events that affect the financial statements or require disclosure</li> <li>▪ Inconsistent application of manual control procedures</li> </ul>	<ul style="list-style-type: none"> <li>▪ Failure to define roles and responsibilities in the financial reporting process</li> <li>▪ Lack of communication of roles and responsibilities to those responsible for performing control functions</li> <li>▪ Lack of training or on-the-job feedback</li> </ul>	<ul style="list-style-type: none"> <li>▪ Written job descriptions define responsibilities for key roles.</li> <li>▪ IT personnel receive regular technical training, as does the CFO. Other accounting personnel do not receive technical training.</li> </ul>	Effective	Inq – 1,2,3,4 Ins – 3

<sup>5</sup> AAG *Assessing and Responding to Audit Risk in a Financial Statement Audit*.



## Exhibit 4-7 Evaluation of entity-level controls 389 (continued)

### Relevant control objectives, risks, and features

Control objectives	Risks of failure to achieve the objective	Indications that the control objective is not being met	Implemented control features	Control design?	Ref.
Individuals involved in the financial reporting process receive the accurate, timely information that is necessary to perform their jobs.	<ul style="list-style-type: none"> <li>▪ Inaccurate accounting records</li> <li>▪ Failure to capture, record, and process all transactions and events that affect the financial statements or require disclosure</li> </ul>	<ul style="list-style-type: none"> <li>▪ Failure to identify information needed to perform financial reporting tasks</li> <li>▪ IT systems cannot reliably deliver timely, accurate information in a usable format.</li> </ul>	<ul style="list-style-type: none"> <li>▪ There is only an informal understanding of the information needed to perform financial reporting functions.</li> <li>▪ Most of the purchased software is three to five years old, and based upon the company's rapid growth and diversification, is now somewhat limited in its ability to keep pace with functional business requirements.</li> <li>▪ Likewise, the hardware and technical environment is nearing its capacity.</li> </ul>	Deficiency noted – see part II CD-5	Inq – 3,4,5,7

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## Knowledge check

1. Generally accepted auditing standards requires documentation of the auditor's understanding of internal control
  - a. On all audits.
  - b. Only when controls are effective.
  - c. Only when the auditor tests controls.
  - d. Only when the financial statements are based on GAAP.

# Tests of details

Tests of details are audit procedures in which amounts that make up an account balance, class of transactions, or disclosure are compared with corroborating information. These tests are generally directed at balance sheet accounts and used to test the existence, ownership, and valuation of assets and the existence, obligation, and amount of liabilities. Examples of tests of details include: an account analysis of the balance in the account at the end of the period, observation of marketable securities, and recalculation of depreciation expense.

The auditor should document the following for tests of details:

- The nature, timing, and extent of the tests
- The linkage of those procedures with the assessed risks at the relevant assertion level
- The results of the audit procedures

An auditor who has not requested confirmations in testing accounts receivable is required to document how he or she overcame the presumption that the auditor will confirm accounts receivable unless either

- Accounts receivable are immaterial;
- The use of confirmations would be ineffective, or
- The auditor's combined assessed level of inherent and control risk is low and the evidence expected to be provided by substantive procedures is sufficient to reduce audit risk to an acceptably low level.

For tests of details, working papers generally show the following:

- The account balance
- Date of the balance tested
- Test procedures applied
- Items to which tests were applied
- Any items that were not suitably supported, and their disposition
- Abstracts or copies of significant contracts or agreements that were examined to evaluate accounting for significant transactions

When the test of details is done on a sampling basis, the working papers may also show

- How the sample size was determined;
- How the sample was selected; and
- How the misstatements found were projected to the population.

For a procedure requiring inquiries of specific entity personnel, the auditor may record

- The dates of the inquiries;
- The names and job designations of the entity personnel;
- The inquiry made; and
- The response received.

For an observation procedure, the auditor may record

- The process or subject matter being observed;
- The relevant individuals;

- Their respective responsibilities; and
- Where and when the observation was carried out.

In identifying the items confirmed or inspected, the working papers often list each individual item. However, depending on the selection criteria, a detailed list might not be necessary. The chart below suggests minimum documentation requirements for various methods of selecting items to be tested.

Selection criteria	What might be documented
Haphazard or random sample	Identifying characteristics (for example, the specific invoice numbers of the items included in the sample)
All items over a specified dollar amount	The scope and the identification of the listing (for example, all invoices over \$25,000 from the December sales journal)
Systematic sample	Identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of shipping reports was selected from the shipping log for the period from X to Y, and starting with report number 14564 and selecting every 250th report from that point)

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## Knowledge check

- The auditor is NOT required to document
  - The nature, timing, and extent of tests of details.
  - The linkage of tests of details with the assessed risks at the relevant assertion level.
  - The results of the audit procedures for tests of details.
  - A decision not to confirm immaterial accounts receivable.

# Analytical procedures

Analytical procedures involve the study and evaluation of financial information through the comparison of relationships among data. The auditor creates an expectation based on a plausible relationship among the data, compares the actual relationship to the expectation, obtains explanations for unexpected variations from the expectation and obtains corroboration for the explanation. Examples of analytical procedures include

- Comparisons with comparable periods;
- Trend analysis;
- Comparisons with anticipated results; and
- Comparisons with industry data.

Analytical procedures have assumed vital functions within the audit engagements:

- These tests, if well-conceived, designed, implemented, and evaluated, can be more effective and efficient than other kinds of substantive tests.
- Analytical procedures are substantive auditing procedures that should be used to direct the auditor's attention to financial statement areas with the highest potential for material misstatement.
- They are effective in the area of evaluating going concern issues, since this judgment is based on careful consideration of profitability, liquidity, and solvency measures of the company's performance, which are derived principally from ratio analysis.
- They identify situations where transactions have not been captured by the accounting system; thus providing competent evidence to assess the completeness assertion. Tests of details (vouching) and tests of balances (confirmations) are limited to *recorded* amounts.
- Analytical procedures are useful in developing and evaluating fraud risk assessments under AU-C section 240.
- Analytical procedures must be used in the final review of the financial statements to assess the overall reasonableness of the numbers contained therein.

When performing analytical procedures, regardless of whether they are in the *overall or account analysis* form, the auditor goes through five distinct thought processes:

1. Establishment of expectations
2. Design of analytical procedures by tailoring to the entity and industry
3. Determination of the extent of analytical procedures to perform
4. Evaluation (Is there a variance?)
5. Effect of the results (So what?)

---

## Documentation requirements

When an analytical procedure is used as a *substantive procedure*, AU-C section 520 specifically requires the auditor to document the following:

- The expectation, when not otherwise readily determinable
- The factors considered in developing the expectation, if not otherwise readily determinable



- Results from the comparison of the expectation to recorded amounts (or ratios determined from recorded amounts)
- Any additional auditing procedures performed in response to significant unexpected differences and their results

Expectations or factors considered in developing expectations that are readily determinable from the working paper do not have to be separately documented. For example, if a test compares the current year balance to the prior year, it is clear that the current year is expected to be comparable to the previous year. However, when they are not expected to be directly comparable, the expectation and basis for it need to be documented. When in doubt about whether the expectation or basis for it is readily determinable, it is generally best to add the documentation. Failure to document expectations is a common peer review finding

In addition, the working papers generally show

- The balance tested;
- The date of the balance tested;
- Explanation of unexpected variations from the auditor's expectation; and
- Evidence corroborating the explanation.

While GAAS does not require documentation unique to analytical procedures used in risk assessment or the overall review stage of the engagement, the general documentation standards require documentation of the procedure applied, the results, and significant findings or judgments. Accordingly, the documentation normally includes the comparison made, the auditor's expectation, and the follow up on unexpected variances.

The following exhibits illustrate documentation of various types of analytical procedures.



## Exhibit 4-8 Expected increase in revenue

A practitioner is auditing the financial statements of a company that manufactures components that are utilized by other companies in customizing vehicles for use by the United States military. Because of various conflicts occurring in the world and the United States' role in those conflicts, the auditor reasonably expects sales to increase. Using his or her knowledge of the client, the client's business, and the industry in which the client operates, the auditor expects a 10 percent to 15 percent increase in sales. Further, the auditor concludes that receivables should increase and that loans payable and interest expense would also increase as the client would need to borrow money to fund the additional production.

### Sample Documentation

#### Expectations

The following are factors that should affect the relationship between current and prior year amounts:

- Increase in military spending by the government due to world events should result in an increase in sales. Based on the DoD's announced commitments, we expect an increase between 10 percent and 15 percent in both sales and accounts receivable.
- Because of an increase in production of military vehicles, the Company had to borrow additional funds to fund production. Therefore, expected increase in loans payable and interest expense between 10 percent and 15 percent.
- No significant change in either days sales in inventory or inventory turnover is expected.

#### Trend Analysis

	20X2	20X1	Change	% Change
Sales	\$2,500,000	\$2,175,000	\$325,000	14.94%
Cost of goods sold	1,780,000	1,566,000	214,000	13.67%
Gross margin	720,000	609,000		
Gross margin as a % of sales	28.80%	28.00%		
Interest expense	48,000	42,000	6,000	14.29%



## Exhibit 4-8 Expected increase in revenue (continued)

### Balance Sheet Ratio Analysis

	20X2	20X1	20X0
Accounts receivable, net	\$1,100,000	\$843,000	\$703,000
Inventory	1,000,000	832,000	694,000
Loans payable	498,000	437,000	418,000
% Increase in loans	13.96%		

### Days Sales in Receivables

Days sales in receivables = Accounts receivable, net at end of period / (Net sales/365)

Current year days sales in receivables = \$1,100,000 / (\$2,500,000/365) = 161 days

Prior year days sales in receivables = \$843,000 / (\$2,175,000/365) = 141 days

The increase of 20 days sales in receivables (161 days – 141 days) represents a 14 percent increase. Controller informed us that the increase results from the bulk of the increase in sales occurring in the fourth quarter. See analysis corroborating that on w/p xx.

### Days Sales in Inventory

Days sales in inventory = Inventory at the end of period / (Total cost of goods sold / 365)

Current year days sales in inventory = \$1,000,000 / (\$1,780,000 / 365) = 205 days

Prior year days sales in inventory = \$832,000 / (\$1,566,000 / 365) = 194 days

The increase of 11 days sales in inventory (205 days - 194 days) represents a 6 percent increase. Controller informed us that this was due to the build-up of inventory at year end in anticipation of increased sales in the fourth quarter and next year's first quarter. See analysis, w/p xx.

### Inventory Turnover

Inventory turnover = Cost of goods sold / Average inventory

Current year inventory turnover = \$1,780,000 / ((\$1,100,000 + 832,000) / 2) = 1.84 times

Prior year inventory turnover = \$1,566,000 / ((\$832,000 + 694,000) / 2) = 2.05 times

The inventory turnover decreased 10 percent. See the explanation under days sales in inventory, preceding.



## Exhibit 4-8 Expected increase in revenue (continued)

### Loan Payable and Interest Expense

Loan increased in line with our expectations.

The loan carries an interest rate of 10%. Expected interest expense should approximate the average of the beginning and ending loan balances times 10%

Expected interest =  $(498,000 + 437,000)/2 = 467,500 \times .10 = \$46,750$

Interest expense = \$48,000, in line with our expectations.



## Exhibit 4-9 Expected decrease in revenue

The practitioner is engaged to audit the financial statements of a client that owns and manages a shopping mall. Due to a poor economy, the mall lost tenants during the year; accordingly, the auditor reasonably expects revenue to decrease. Using his or her knowledge of the client, the client's business, and the industry in which the client operates, the auditor expects a 5 percent to 10 percent decrease in revenue during the year. Further, the auditor expects that general and administrative expenses should increase due to an increase in leasing and sales activity and that management fees should decrease due to a decrease in tenants in the building.

### Sample Documentation

#### Expectations

The following are factors that should affect the relationship between current and prior year amounts:

- Loss of tenants due to poor economy should result in a decrease in revenue. Based on discussions with the client and our observation of the facility, we estimate the vacancy rate increased between 5 percent and 10 percent.
- Because of the increased number of vacancies, general and administrative expenses are expected to increase to reflect an increase in leasing and sales activity. Expected increase between 5 percent and 10 percent (roughly equivalent to the increase in the vacancy rate).
- Because of the decrease in the number of tenants in the building, management fees are expected to decrease between 5 percent and 10 percent.



## Exhibit 4-9 Expected decrease in revenue (continued)

Balance sheets and income statements are available for the current and two years preceding the current year.

### Trend Analysis

	20X1	20X2	Change	% Change
Tenant revenue	\$7,223,000	\$8,603,000	\$(1,380,000)	(16.04)%
Costs and expenses:				
Management fees	339,000	387,000	(48,000)	(12.40)%
General and administrative	583,000	511,000	72,000	14.09%

[Similar balance sheet analytics should be performed as those performed in the prior exhibit.]

Because the results of the analytical procedures do not agree our expectations we inquired about the reasons for the decrease in tenant revenue, the decrease in management fees, and the increase in general and administrative expenses exceeded expectations, and were told that [explanation]. Our analysis and evidence corroborating those explanations are documented at w/p xx.



### Case study 4-1: Working paper design

While doing the work on ABC Company's allowance for doubtful accounts at 12/31/X2 the auditor determined the following:

- a.* The allowance for doubtful accounts was \$154,000 at 12/31/X2.
- b.* The year-end allowance was \$143,000 in 20X1 and \$123,000 in 20X0.
- c.* ABC Company wrote off \$20,000 against the allowance during 20X2; the prior year's write-offs totaled \$60,000.
- d.* The total write-offs for 20X2 agreed to a detailed listing shown on another working paper, number C12, where the amounts were agreed to accounts receivable balances.
- e.* Total accounts receivable (before the allowance) was \$2,563,000 at 12/31/X2 and \$2,424,000 at 12/31/X1.
- f.* Sales were \$15,563,000 for 20X2 and \$14,625,000 for 20X1.
- g.* In response to the auditor's inquiry, the company's vice president of credit explained unexpected relationships in the data. (The actual response is not detailed in this exercise.)

Required: Prepare a working paper that documents the work done. (Assume the working paper listing the details of the 20X2 write-offs in item c exists elsewhere in the audit documentation so there is no need to create it here. It is not necessary to create the vice president of credit's explanation for unexpected fluctuations, merely indicate how it would be documented.)

# Summary

This chapter discussed and illustrated documentation of

- the linkage of risks, assertions, and tests;
- internal control;
- tests of details; and
- analytical procedures.

Traps to avoid include

- failing to document expectations;
- lack of tailoring to client; and
- not documenting the analytical procedures used by partners in final analytical review.







## Chapter 5

# Working Paper Critique

---

### Learning objective

After completing this chapter, you should be able to do the following:

- Recognize effective versus ineffective working paper techniques.
- 

### Introduction

The examples presented do not purport to show minimum or suggested audit procedures to be employed but are included solely for illustrative purposes. The nature, timing, and extent of audit procedures and the form and content of working papers are the result of professional judgment that the auditor makes in the individual circumstances.

# The good

Review the exhibits that follow and then read the comments about them.



Exhibit 5-1

Raintree Enterprises  
Fixed Asset Summary Schedule  
12/31/X1

A/C No.	Description	Balance 1/1/X1	Cost	Disposal/ Retirement	Balance 12/31/X1	Balance 1/1/X1	Accumulated Depreciation	Balance 12/31/X1
			Additions				Expense	
4001	Land	100,000			100,000	✓		129,425
4002	Buildings	925,621			925,621	TB		273,415
4003	Furn & Equip	740,317	161,291	17,609	883,999	TB	23,132	15,882
4004	Machinery	1,260,881	2012,163	26,801	1,435,243	G-2	78,691	G-11
4005	Vehicles	375,207	47,810	35,207	387,810	G-3	95,842	20,915
	Total	3,402,026	410,264	79,617	3,732,673	TB	50,694	30,810
							248,359	172,493
	Adjustments		61,218		61,218	①	2,506	1,046,011
	Adjusted Tot.	3,402,026	349,046	79,617	3,671,455	✓	245,853	1,403,505

TB Agreed to trial balance  
✓ Footed or crossfooted  
L Agreed to 12/31/X0 workpapers

① Adjust machinery balances as follows

Cost	Depreciation
1,435,243	470,678
(61,218)	(2,506)
<u>1,374,025</u>	<u>468,172</u>
TB	TB

(Booked AJES)

Comments on exhibit 5-1:

- The presentation is in *10-K format*. That is, it shows the prior year's balance, additions, subtractions, and the current year's balance. In an account such as property and equipment, which builds each year, the auditor focuses attention on incremental activity. This is a very useful format, especially when you have audited the opening year's balance in prior years. In other types of accounts, such as those that turn over each year (for example, accounts receivable), this approach is less useful. In those cases, it is more useful to focus on the components that make up the ending balance than on activity.
- The schedule was prepared by the client (PBC). This, of course, is a time-saver.
- Opening balances were all agreed to the previous year's working papers. The tickmark legend explains this tickmark. However, it is often more efficient to have a standard tickmark for this as well as for footed, calculated, and agreed to trial balance. The schedule was footed and crossfooted. When the client prepares a schedule, it is important to show that the arithmetic was checked.
- The detail of activity is tested on other working papers. The cross-references, for example, G-3 and G-7, show where that procedure is performed. It is clear that all the activity has been considered, although one has to look at the detail working papers to see the work actually done. The cross referencing can be done through hyperlinks.
- The balances were agreed to the trial balance, which is ultimately used to prepare the financial statements. When an adjustment is proposed and made, the working papers show the adjusted balance.
- The schedule has been signed by the staff person doing the work and the person who reviewed it.



## Exhibit 5-2

Raintree Enterprises  
A/C 4004 - Machinery - Additions/Disposals  
12/31/X1

W/P No. **G-3 PBC**

Prepared by: LA Date: 2/14/X2

Reviewed by: VS Date: 2/19/X2

Balance beginning of year	1,260,881.37	<b>G-1</b>
Additions:		
12/14 Calibrator (#6123)	18,694.14	<b>A</b>
3/26 Addition to #1 machine	32,409.77	<b>B</b>
4/7 Welder interface (#6204)	21,789.42	<b>A</b>
6/21 Loader (#6290)	10,339.88	<b>A</b>
8/14 Addition to #4 machine (#6401)	61,217.72	<b>C</b>
10/24 Cutter assembly (#6492)	29,807.40	<b>A</b>
various Additions under \$5,000 each (8 items)	<u>26,904.81</u>	
Total additions	201,163.14	✓ <b>G-1</b>
Disposals/Retirements		
6/25 Sale of old welder (#2626)	14,832.17	<b>D</b>
12/14 Retirement of corker (#2402)	<u>11,968.97</u>	<b>G-15</b>
Total disposals/retirements	26,801.14	✓ <b>G-1</b>
Balance end of year	<u><u>1,435,243.37</u></u>	✓ <b>G-1</b>

### Tickmark Legend:

- ✓ Footed or crossfooted
- A** Agreed amount, description, and acquisition date to invoice
- B** Capital improvement project done by client personnel (see test of build-up on W/P G-4)
- C** Project initially recorded as a capital improvement project. As described on W/P G-6, actually represents ongoing repairs and maintenance.

### Proposed AJE #5:

Dr. Repairs and maintenance expense 61,217.72  
Dr. Accumulated depreciation 2,506.17 **G-14**  
    Cr. Machinery 61,217.72  
    Cr. Depreciation expense 2,506.17 **G-14**  
*(to record work on #4 machine as repairs and maintenance)*

- D** Sold for \$6,100. Agreed amount to cash receipts journal.

Net gain: Sales price 6,100.00  
  
Cost 14,832.17  
Accum Deprn 8,945.84 **G-15**  
5,886.33  
Net gain **213.67 W-1**

Comments on exhibit 5-2:

- This was also prepared by the client and the arithmetic accuracy was checked.
- The auditor checked that the amounts shown here agreed to the summary schedule (which, in turn, agreed to the trial balance).
- The work done on purchases is clearly described. The amount, description, and acquisition date were considered.
- There is apparently no work done on the minor additions. This, and the reasons for it, seem clear. The individual amounts are immaterial, and even in total it does not become material. However, if the scope decision is not specified in the planning working papers or the audit program, it should be noted on this working paper so it is clear that the scope decision was not determined by the client.
- It is clear that the test of the buildup of capitalized costs was done on another working paper (G-4).
- The work on the inappropriately capitalized costs was done on working paper G-6. The adjusting journal entry was proposed here and should also be shown on a schedule of proposed adjustments. When the client agreed to book the adjustment, the summary schedule (G-1) was updated.
- The work on the gain from the sale of machinery is done here for efficiency purposes. It is simple to do while the auditor is doing this work.

# The bad

## Audit programs



Exhibit 5-3 Audit program

Step	Procedure	W/P ref	Done by	Date
J.2	Obtain a schedule of accounts payable as of the balance sheet date.	J-2.5	CBS	2/14
	a. Test the arithmetic accuracy of the schedule			
	b. Agree the total to the trial balance			
J.3	Trace amounts to supporting documents such as invoices to determine if the amount was owed at the balance sheet date.			
	a. All balances over \$10,000			
	b. Sample balances under \$10,000 using the firm's sample-size selection form			
J.4	Consider mailing confirmations to selected creditors			
J.5	Consider whether reclassification of debit balances is necessary.			

Comments on exhibit 5-3:

Some auditors save time by signing off a large portion of the audit program in one motion, similar to that shown in exhibit 5-3. This should be avoided. The time saved is incredibly small. Auditors who use this technique also might not adequately focus on the specific requirements of each test and, thus, fail to carry out appropriately each part of each task. Signing off each step is a more effective way of ensuring that each step was done.

## Analytical procedures

If a computerized audit package automatically produces a standard set of ratios and other comparisons, ensure that each one included in the working papers is adequately considered. The working papers should make clear how each unusual relationship identified was investigated and resolved, as well as the reason for decisions not to follow up apparently unusual relationships.

It is hard to defend working papers after the fact in a lawsuit when the auditor missed a material misstatement that is obvious from the analytical comparisons appearing in the working papers but not followed up.

## Shortsighted analyses

Refer to exhibit 5-4, which presents an analytical comparison of income statement data.



**Exhibit 5-4**

Farside Industries, Inc.  
Analytical Comparisons--P&L  
12/31/X1

W/P No. **C-3**

Prepared by: WAB Date: 1/28/X2

Reviewed by: Date:

	<u>20X1</u>	<u>20X0</u>	<u>Increase/ (Decrease)</u>	<u>Analysis</u>
Sales:				
Line A	8,531,000	5,107,000	3,424,000	Higher sales
Line B	3,249,000	60,000	3,189,000	New line
Expenses:				
Purchases	1,650,000	808,000	842,000	New line
Wages-Line A	620,000	598,000	22,000	Pass-immaterial
Supplies-Line A	381,000	360,000	21,000	
Rep and maint.-Line A	194,000	203,000	(9,000)	
Wages-Line B	310,000	44,000	266,000	New line
Supplies-Line B	186,000	10,000	176,000	
Rep and maint.-Line B	67,000	14,000	53,000	
Supervision	240,000	107,000	133,000	

When analyzing year-to-year balances, it is important to keep in mind the substance of the numbers and not just the numbers themselves. It is important to consider unexpected fluctuations, but it is just as important to recognize the absence of "expected" fluctuations. In exhibit 5-4, the auditor purports to have analyzed the operating fluctuations between two years.

In this case, the auditor comes to the following findings:

- Concluded that the increase in product A sales is due to higher sales without any indication of whether this represents more units, a higher sales price, or both
- Attributed the increase in purchases to the new product: although this may be true, purchases might also be related to the sales increase in product A. Perhaps a mere doubling of purchases is lower than expected, given the increase in sales. Or, perhaps it is a function of timing and changes in inventory levels and not correlated to cost of sales.
- Determined that the year-to-year fluctuations in product A expenses are immaterial: this ignores the possibility that the increased sales revenue represents an increase in unit sales, which is what the increase in purchases might suggest. If that were the case, operating expenses would be expected to be much higher than in the previous year instead of being relatively similar.
- Decided that the doubling of supervision expense is due to the new product: this does not address whether supervision is a variable cost that should double with the increase in volume or whether it is largely fixed and should be unaffected by volume.

---

## Blithe comments

Refer to exhibit 5-5, which illustrates a portion of a memo describing physical inventory observation.



### Exhibit 5-5 Inventory observation – I

The inventory observed at the east end of the Columbia warehouse is not really the client's; it has been sold. Although the paperwork is not done, this is not unusual. The client often plays "fast and loose" with procedures. I conclude that this is a bona fide sale and no further work deemed necessary.

Language used in working papers should be free from gratuitous comments or those that could be misinterpreted or taken out of context. If the staff person has concerns about the appropriateness of recorded amounts or client actions, the concerns and the ultimate resolution should be clearly spelled out in the working papers.

This example raises questions about (1) the existence of a significant deficiency or material weakness in internal control, and (2) the appropriateness of the client's revenue recognition policies.

Refer also to exhibit 5-6, which presents another inventory memo.



### Exhibit 5-6 Inventory observation – II

The client had completed the count prior to our arrival. The controller gave us a tour of the plant. All inventory was neat and orderly. All inventory appeared to be properly ticketed. Upon client's instructions, two of our staff were assigned to test-count finished goods (due to high dollar value) and one was assigned to raw materials and work in process.

The language used in the working papers should make it clear who actually made the strategic decisions. In exhibit 5-6, it appears that the client made the decision. It is also not clear if the dollar value of the inventory was the right basis for the decision. For example, the total of raw materials and work in process might exceed that for finished goods. Alternatively, the dollar value of work in process might be slightly less than finished goods but more complex to audit.

---

## Review notes

Refer to exhibit 5-7, which presents a review note from a supervisor to the staff auditor.





### Exhibit 5-7 Review note

Comment	Response
The analysis of the allowance for doubtful accounts is woefully inadequate. While the work is well cross-referenced and amounts compared to the previous year, there is too little work done to determine whether the allowance is appropriate in view of the large increase in accounts receivable this year.	Noted; no change made.

Review notes are comments, criticisms, observations, and suggestions made by the working paper reviewer for the preparer's consideration and follow-up. Some firms retain them; others discard them after the audit. In either case, when the review notes call for more work or better documentation, the additional work or documentation should appear on the working papers themselves, not just on the review notes. The reviewer should be satisfied that the comment was addressed adequately and that the working papers reflect the work done and the basis for any conclusions reached.

Exhibit 5-7 illustrates a case when this was not done. It appears that the staff person made no changes at all to the work on uncollectible accounts. It is unclear why, but it is likely the working papers were no better after the review than before.

---

## Indexing and cross-referencing

Most firms have developed their own systems of indexing working papers. Any system that is understandable to the staff is acceptable. However, the following matters might be considered in developing a system.

Using numbers that do not run consecutively makes understanding the working papers difficult. For example, one system always numbers the lead schedule of a section "1," the analysis of prior years' passed adjustments "2," and other schedules starting with "3." If a section has no working paper numbered "2," it is not clear whether there were no prior year passed adjustments to consider or whether the working paper was simply omitted.

Using an overly complex numbering system makes it difficult to follow the working papers. The complexity increases with the number of subsections. For example, does working paper C-1/a-1 come before or after C-1/1-a?

---

## Adjustments

Adjustments posted to the trial balance should be reflected on the working papers that show the detailed work. The effect of the adjustment might be clear to the staff person who did the work. However, when the detail does not agree to the final amounts, persons who come along later, such as reviewers, the

following year's staff person, or peer review teams, might have trouble determining whether the amount shown in the final audited financial statements was the amount actually tested by the staff person.

---

## Knowledge check

1. A potential danger unique to computerized working papers that produce a standard set of ratios and comparisons is that
  - a. The comparison will omit certain ratios required by generally accepted auditing standards.
  - b. The volume of output might be larger than the auditor needs and the auditor might fail to adequately follow up unusual relationships in unexpected areas.
  - c. The calculation might be incorrect.
  - d. It costs too much time.
2. Written notes made by supervisors during review that instruct subordinates to follow up or correct items in the working papers should be
  - a. Thrown away after the items have been followed up.
  - b. Discouraged by the firm.
  - c. Kept for future reference.
  - d. Retained or discarded based on auditor preference.

# The ugly

Exhibits 5-8 through 5-13 contain examples of working papers that you should review and critique in the spaces provided. Your comments should include any errors or omissions and any comments for improving the overall quality of the working papers.



**Exhibit 5-8**

**Alpha Products, Inc.  
Cash Reconciliation  
12/31/X1**

W/P No.

**PBC**

Prepared by:

Date:

Reviewed by:

Date:

A/C 109

Balance per bank statement 12/31/X1	318,010	C
Add: Deposits in transit, per list below	32,090	←
Less: Outstanding checks, per list below	153,450	C
Balance per books	196,650	
Debit memo charged by bank	<u>1,120</u>	✓
	<u>195,350</u>	

**Deposits in transit:**

Date per

Client

Bank

12/14	1/2	5,500	A
12/18	1/2	5,500	A
12/22	1/2	5,500	A
12/29	1/3	6,590	S
12/30	1/4	<u>9,000</u>	S
		<u>32,090</u>	←

✓

- A** Why so long to clear?
- C** Per bank confirmation
- ✓
- S** Traced to bank statement
- C** Examined cancelled checks

Your comments on exhibit 5-8:

Comments on exhibit 5-8:

Some, but not necessarily all, of the more obvious deficiencies are:

- The working paper is not properly titled.
- The preparer did not sign or date it.
- There is no indication that it was footed (it does not foot).
- There are no outstanding checks "per list below."
- There is no explanation of the debit memo, nor is it clear whether an adjusting entry is required.
- The reason for the bank's delay in crediting the (3) \$5,500 deposits in transit is not explained, nor is it clear that the deposits were traced to the bank statement.
- The tickmark (C) is used twice to explain different audit steps – comparing with the bank statement and examining the canceled checks – which can be confusing. Tickmarks should be limited to one explanation per working paper.



## Exhibit 5-9

### Alpha Products, Inc. Accounts Receivable Aged Trial Balance

W/P No.  
Prepared by: JR Date: 2/9/X2  
Reviewed by: Date:

Customer	Balance		Age of Account--No. of Days				Confirm	
	Dr	Cr	< 30 days	31 - 60	61 - 90	> 90 days	Requested	Remarks
Adams Supply Co	45,420		32,170	13,250			✓	
Baker Chemicals	7,718		5,218	2,500			✓	
Brown Bag Co, Inc.	10,615		10,165			450		
Crosstown Equip. Rentals	450		450				✓	
Davenport Mfg.	218				218			
Douglas Electrical	2,911		1,500	1,411				
Evans Supply Co.	11,177					11,177		
Favorite Decorators	7,705		5,500	2,205				
T.T. Farrow Inc.		1,500						
Great American Plumbing	13,820		13,820				✓	
Gargoyle Crafters		4,000						
Harrison Bros.	5,816				5,816			
Johnson Packing Corp.	1,785					1,785		
Krusty Products	532			532			✓	
Kubic Auto Parts	119		119				✓	
Lanza Fabricators	32,437		21,350	11,087				
Life & Waite Clothes		3,000						
Murdoch Machine	122,243		72,443	49,800			✓	
Murray Bros Hauling	811		811					
Patterson Publishing Co.	4,750					4,750		
Reed Processing	868		868				✓	
Smith Tool & Die	1,000				1,000			
Taylor Electrical		6,500						
Weiss Welding Co.	5,150		3,000	2,150				
Young Supply Corp.	3,700					3,700		
Zeus Hauling	2,870		2,000	870				
	282,115	15,000	169,414	83,805	7,034	21,862		
	<b>W</b>							

Your comments on exhibit 5-9:

Comments on exhibit 5-9 may include the following:

- Although signed and dated, the working paper is not complete and contains no verification procedures.
- The date of the aged trial balance is missing.
- The source of the aged trial balance—the client's subsidiary ledger—is not indicated, nor is there any indication that the aging of individual accounts was compared with the subsidiary ledger.
- There is no indication of the method by which accounts were selected for confirmation. In addition, it looks as if an attempt was made to ignore possible problem areas. For example, only accounts with balances due within 60 days were selected for confirmation.
- The working paper does not indicate that the total agrees with client's records. Additionally, because the cross-footed total does not include the total for the credit balance column, it is not clear just what this figure represents.
- The working paper indicates that certain confirmations were requested, but no replies are indicated, nor is there any indication that subsequent collections were traced to cash receipts.
- There is nothing to indicate that collectability of the accounts was considered.
- There is an unexplained tickmark beside the debit balance total.



## Exhibit 5-10A

Alpha Products Inc.  
Property, Plant & Equipment and Depreciation Summary

W/P No. J-1  
Prepared by: GW Date: 1/11/X3  
Reviewed by: Date:

Assets						Accumulated Depreciation					
Classification	Final 12/31/X1	Additions	Removals	Balance 12/31/X2	W/P ref.	Method Est. Life	Final 12/31/X1	Additions	Removals	Balance 12/31/X2	W/P ref.
Land	50,000			50,000	J-1						
Buildings	500,000	15,000		515,000	J-2		140,000	15,000		155,000	J-2
Machinery	1,250,000	175,000	65,000	1,360,000	J-3		600,000	65,000	15,000	650,000	J-3
Office equipment	128,500	13,650	4,550	137,600	J-4	S/L 5-10 yr	55,000	8,000	2,950	60,050	J-4.2
	<u>1,928,500</u>	<u>203,650</u>	<u>69,550</u>	<u>2,062,600</u>			<u>795,000</u>	<u>88,000</u>	<u>17,950</u>	<u>865,050</u>	
	F	F	F	F			F	F	F	F	

Allocation of depreciation	
Mfg Dept.	70,400
Sales	8,800
G&A	8,800
	<u>88,000</u>

✓ Examined invoice  
C/R Traced to cash receipts journal  
CM Calculation checked for reasonableness  
PY Traced to prior year's workpapers  
F Footed



## Exhibit 5-10B

Alpha Products Inc.  
Office Equipment Summary  
12/31/X2

W/P No. **J-4**

Prepared by: GW

Date: 1/11/X3

Reviewed by:

Date:

12/31/X1	Balance per general ledger		128,500	
	Additions:			
2/15/X2	Blue Lightning--Photo copier (new)	8,400	✓	
6/20/X2	Baldwin Furniture--Desk and chair (new)	1,500	✓	
8/4/X2	Zeus Calculators--5 desk calculators (new)	2,750	✓	
11/30/X2	Custer Materials--Tape recorder (used)	<u>1,000</u>	✓	
	Total additions		13,650	
	Removals:			
3/24/X2	Copier--sold	3,500		
5/7/X2	Desk--scrapped	750		
7/11/X2	File cabinet--fully depreciated	<u>300</u>		
	Total removals		<u>4,550</u>	
12/31/X2	Balance per general ledger		<u>137,600</u>	J-1
			F	



## Exhibit 5-10C

Alpha Products, Inc.  
Office Equipment--Disposals

W/P No. **J-4.1**

Prepared by: GW

Date: 1/11/X3

Reviewed by:

Date:

Date						
Acq	Disp	Description	Cost	Accum. Dep'n	Proceeds	Gain (Loss)
1/X0	3/X2	Blue Lightning copier--sold to H. Clark	3,500	2,100	2,000 CR	600
4/W9	5/X2	Oak desk--scrapped, not worth repairing	750	550		(200)
7/W7	7/X2	File cabinet--remove, fully depreciated	<u>300</u>	<u>300</u>		
		Total	<u>4,550</u>	<u>2,950</u>	<u>2,000</u>	<u>400</u>
			F	F	F	F



## Exhibit 5-10D

### Alpha Products, Inc. Office Equipment--Depreciation

W/P No. **J-4.2**

Prepared by: GW

Date: 1/11/X3

Reviewed by:

Date:

<u>Description</u>	<u>Life</u>	<u>Method</u>	<u>Reserve</u> <u>12/31/X1</u>	<u>20X2</u> <u>Dep'n</u>	<u>Disposals</u>	<u>Reserve</u> <u>12/31/X2</u>
Furniture	10 yrs	S/L	25,000	3,000 ©	550	27,450
Fixtures	10 yrs	S/L	25,000	3,000 ©	300	27,700
Equipment	5 yrs	S/L	<u>5,000</u>	<u>2,000</u> ©	<u>2,100</u>	<u>4,900</u>
Total			<u>55,000</u>	<u>8,000</u>	<u>2,950</u>	<u>60,050</u>
			<b>F J-1</b>	<b>F J-1</b>	<b>F J-1</b>	<b>F J-1</b>

Your comments on exhibits 5-10A-D:

Comments on exhibit 5-10A :

(J-1) Property, Plant, and Equipment, and Depreciation Summary:

- Although the tickmark (PY) per the legend refers to agreement with the prior year's working papers, it has not been used in conjunction with the prior-year balance column; it is not clear whether those balances were actually agreed to the prior-year working papers.
- The basis for allocating depreciation among manufacturing, sales, and G&A is not given, nor is it indicated whether the allocation is consistent with the prior year.
- Client's general ledger account numbers should be shown.
- The ending balances should be referenced to the trial balance.

Comments on exhibit 5-10B:

(J-4) Office Equipment – Summary:

- No account number is shown.
- The working papers should state that the explanation for tickmark (F) is on the lead sheet (J-1).

Comments on exhibit 5-10C:

(J-4.1) Office Equipment – Disposals:

- The heading does not indicate the balance sheet date.
- The working paper should contain reference to any relevant income tax considerations, such as whether the client's tax and book depreciation are the same.
- The explanation for tickmarks is not given or cross-referenced to the lead sheet (J-1).
- It should be determined whether significant amounts of fully depreciated assets exist, which should be disclosed.

Comments on exhibit 5-10D:

(J-4.2) Office Equipment – Depreciation:

- Disposals should be cross-referenced to working paper J-4.1.
- The source of the data – fixed asset ledger or other – is not indicated, nor is the account number.
- There is no indication that depreciation expense is computed consistently with the prior year.
- The cost of the office equipment, not just the reserve balance, should be indicated on the working paper for recomputation purposes and to guard against depreciation in excess of the equipment cost.
- The balance-sheet date is omitted from the heading.



**Exhibit 5-11**

Alpha Products, Inc.  
Notes Payable and Accrued Interest Payable  
12/31/X2

W/P No.  
Prepared by: GW Date: 1/11/X3  
Reviewed by: Date:

Description	Date	Interest rate	Original Amount	Balance 12/31/X1	Additions	Note Payment Date	Payment Made	Balance 12/31/X2	Accrued 12/31/X1	Interest Expense	Payments	Accrued 12/31/X2
First National Bank. Secured by building. Payable in equal annual amounts plus interest. Due 3/1/X4	3/1/W9	10%	500,000 A	300,000		3/1/X2	100,000 CD	200,000 C	22,500	22,500 ✓	30,000	15,000
Second National Bank. Unsecured. Payable at maturity--2/1/X3	8/1/X2	12%	100,000 A		100,000 CR			100,000 C		5,000 ✓		5,000
Third National Bank. Unsecured. Payable at maturity--2/1/X3	8/1/X2	9%	100,000 A		100,000 CR			100,000 C		3,750 ✓		3,750
Total				300,000 PY	200,000		100,000	400,000 TB	22,500 PY	31,250	30,000	23,750 TB

- A Authorization examined.  
C Terms and balance agree with confirmation.  
✓ Calculation checked for reasonableness.  
CR Traced to cash receipts journal.  
CD Traced to cash disbursement.  
PY Agreed to prior year's workpapers.  
TB Agreed to trial balance.  
⌚ To interest expense.  
⌚ To accrued interest.

Your comments on exhibit 5-11:

Comments on exhibit 5-11:

- There should be a cross-reference to the building's working paper noting the collateral for the First National Bank loan; the working paper should indicate the current portion of the loans.
- Tickmark (A) might be expanded to indicate just what authorization was examined, for example, permanent file, board of director's resolution.
- The cross-reference to interest expense and accrued interest should contain the appropriate working paper index.

*Note:* Terms for the new debt should be traced to the debt agreement, which should be in the permanent file. Although the working paper indicates that the terms agree with those shown on the confirmation, the information shown in the agreement itself is generally more reliable.

There is a difference between the interest rates for the two new loans, which were taken out on the same day. There should be an indication that the auditor considered the reason for this difference.





## Exhibit 5-12

Alpha Products, Inc.  
Legal Fees  
12/31/X2

W/P No.

Prepared by:

Date:

Reviewed by:

Date:

<u>Attorney</u>	<u>Description of service</u>	<u>Date</u>	<u>Amount</u>	
Johnson, Mead & Soo	Review board of directors minutes, type and file	2/26/X2	1,503	✓
Shope & Shope	Title search for land adjacent to plant	3/11/X2	150	
Dayton & Deans, PC	Partial bill on "Smith Matter" per agreement	6/19/X2	15,000	✓
Lincoln, Webster & Cardozo	Updating pension plan for ERISA amendment, etc.	10/15/X2	<u>12,250</u>	
Total			<u>28,903</u>	



## Exhibit 5-13

Alpha Products, Inc.  
Contributions  
12/31/X2

W/P No.

Prepared by: PB

Date:

Reviewed by:

Date:

<u>Payee</u>	<u>Date</u>	<u>Amount</u>	
American Cancer Society	1/18/X2	500	
St. Joseph's College	2/28/X2	1,000	
American Red Cross	3/14/X2	250	
Tony's Gas Station	5/29/X2	212	
Pleasant County TB Assn	6/2/X2	150	
YMCA	8/1/X2	1,200	
Community Hospital Fund	8/13/X2	2,000	
Pink Slipper Lounge	11/30/X2	188	
Heart Association	12/6/X2	<u>1,500</u>	
Subtotal--all vouched		7,000	
Items not vouched		<u>3,210</u>	
Total		<u>10,210</u>	✓
		<b>TB</b>	

Your comments on exhibit 5-12:

Your comments on exhibit 5-13:

Comments on exhibit 5-12:

- The preparer did not sign and date the working paper.
- There is no indication that the working paper was completely footed and traced to the client's general ledger or trial balance.
- The invoice from Shope and Shope indicates that a title search was done, but the property and equipment working paper (exhibit 5-10A) shows no addition to land. The follow-up and explanation should be shown on the working paper.
- The 6-19-X2 invoice for the "Smith matter" should be further investigated and the "agreement" examined.
- The 10-15-X2 invoice could be described more clearly by detailing the major charges, and avoiding language such as "etc."
- There is no tickmark explanation or index number.

Comments on exhibit 5-13:

- The working paper should indicate the scope of the vouching – for example, all items \$100 or more – and just what is meant by vouching – that is, examined canceled check and/or receipt.
- The amounts listed for Tony's gas station (\$212) and the Pink Slipper Lounge (\$188) need further explanation and possible reclassification.
- There is no tickmark explanation or index number.



## Chapter 6

# Improving Working Paper Technique

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### Learning objective

After completing this chapter, you should be able to do the following:

- Identify ways to improve audit efficiency through effective working paper techniques.
- 

### Introduction

Earlier chapters discussed the basic rules for good working paper preparation. This chapter expands on that discussion to describe some working paper techniques that will improve your working papers and make you more efficient. Although many of these apply only to manually prepared working papers, others apply to both manual and electronic working papers (for example, the first two under “Getting Workpapers Prepared More Economically”).

This chapter presents 19 suggestions that fall into four major categories:

- Getting working papers prepared more economically
- Using them more efficiently
- Improving their clarity
- Using them to avoid unnecessary audit procedures

# Getting working papers prepared more economically

- Whenever possible, have the client's employees prepare schedules and analyses. This, of course, assumes that the client has the necessary personnel to do so. If they do, copies of prior-year working papers – with the tickmarks and other audit procedures deleted – can be provided to the client well in advance of year-end fieldwork and client employees can prepare the schedules or analyses in the format you will need on the audit as they get the chance. Some firms even put this in the engagement letter, a separate arrangements letter, or a client request listing.
- Even if you cannot get the client to prepare working papers in the format you will need, you may still be able to use the efforts of client personnel to reduce your work. If the client prepares schedules or analyses for its own use, you may be able to use copies of them even if they are not precisely in the format you need. Often the work required to add to, or modify, an existing client schedule is less than that needed to prepare the schedule in the right format from scratch.
- Do not manually copy or input a document when photocopying or scanning is feasible.

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## Knowledge check

1. When having client personnel prepare schedules for the auditor, it is allowable to give them copies of the working papers prepared for the previous year's audit.
  - a. Always.
  - b. Never.
  - c. Only if the description of tests applied has been deleted from the copies.
  - d. Only if they are to be prepared by internal auditors.

# Using working papers more efficiently

- Consider analyzing asset or liability accounts and related expense or income accounts on the same working paper. For example, property and equipment, accumulated depreciation, and depreciation expense can be efficiently analyzed on the same working paper. Similarly, notes payable, accrued interest, and interest expense can be shown on a single worksheet.
- Consider other ways to make working papers do double duty. For example, if you are going to have to prepare the client's corporate tax return, you will need information that is otherwise unnecessary for the audit. Gather that information at the same time and on the same working paper, so that you get related information necessary for both the audit and the tax return at the same time.
- Consider using carryforward schedules for accounts that tend to remain constant each year or vary only in accordance with a constant predetermined formula. Examples include fixed assets and related depreciation, long-term debt with predetermined repayment schedules, and capital stock.
- For some clients, account-grouping schedules are necessary for preparing the financial statements. On others, however, you may be able to avoid preparing these schedules by using a trial balance that is sufficiently detailed and classified.
- Prepare documentation at the time the test is done rather than completing it later. Completing it contemporaneously generally results in more accurate working papers, reduces uncertainties that result from relying on memory, and can increase the likelihood that reviews can be efficiently completed in the field.

# Improving working paper clarity

- Consider the form of your working papers before you prepare them. Try to avoid cluttered or sloppy working papers because they are hard to follow.
- If in doubt, use a larger sheet of paper. Using only half of the paper is less of a problem than running out of space and trying to cram in necessary information.
- Although you should try to use photocopies whenever possible, copying machines do not always work properly. Avoid illegible photocopies – they cannot be reviewed properly or read clearly after the audit is over. If possible, use a better machine, wait until the machine is repaired, use a scanner, or, if you have no alternative, copy the information by hand.
- Using a detailed audit program may eliminate the need for lengthy comments in the working papers on the scope of audit procedures. Keep in mind, though, that some auditors believe that such comments are still necessary regardless of the audit program's detail – this is a judgment you and your firm must make.
- Use tickmarks whenever possible. In fact, by using *standardized* tickmarks throughout the engagement or throughout the firm can improve the clarity of working papers and the efficiency of their preparation.
- While cross-referencing related working papers is good, the reasons for working paper cross-references should be clear. Do not cross-reference unless it is relevant to the work being done. The mere fact that the same amount appears on two working papers is not sufficient reason to cross-reference them.
- Be careful in your conclusions. Although you may conclude that the test results were as expected or within acceptable materiality boundaries, do not say that a balance is *fairly stated or fairly stated in conformity with generally accepted accounting principles*. That is a conclusion that applies only to the financial statements as a whole – your audit work on a particular account was probably not sufficient to warrant such a conclusion at an account level.
- Do not rely on answers to review notes or items noted in to-do lists to document your work, even if you retain them. Relying on conclusions contained only on such extraneous material does not provide a clear audit trail and makes later recreation of your considerations and conclusions very difficult. Each working paper, or group of working papers, should stand on its own and contain all the information necessary to understand it.
- When developing Excel formulas in working papers, segregate inputs into separate cells rather than embedding them in formulas. This helps reviewers understand the factors involved and reduces the likelihood of errors when updating formulas.

# Avoiding unnecessary audit procedures

- Avoid unnecessary computations. For example, if only the totals are meaningful and can be tested by a single independent computation, just check the total and avoid unnecessary checking of details or subtotals.
- Show all balances in comparative form. Lead sheets and detail schedules should show last year's balance alongside this year's. This approach makes analytical procedures more effective and efficient. Avoid detailed explanations of insignificant amounts. Often, just a notation saying, "insignificant amount – no detailed audit work considered necessary" is sufficient.
- Be sure you know why you are preparing each working paper. The fact that it was done last year is not a good enough reason to prepare it again this year. Each working paper should help to achieve an audit objective; if it does not, it may be unnecessary.

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## Knowledge check

2. All computations and subtotals on client-prepared schedules should be proven.
  - a. Recommended.
  - b. Not recommended.
  - c. It depends on whether the schedule is manual or computer-generated.
  - d. It depends on whether the data agree to the client's accounting records.

# Summary

The following are four general ways to increase efficiency through improved working paper technique:

1. Getting working papers prepared more economically
2. Using working papers more efficiently
3. Improving working paper clarity
4. Avoiding unnecessary audit procedures





## Chapter 7

# Working Paper Basics

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### Learning objectives

After completing this chapter, you should be able to do the following:

- Apply basic documentation requirements in generally accepted auditing standards (GAAS).
  - Identify common working paper filing methods.
  - Differentiate levels of review to which working papers are subject.
- 

### Introduction

This course discusses the goals of senior-level working paper review, provides guidance on how to review them, and illustrates through examples and a case, common types of problems the senior-level review should detect.

This chapter discusses the requirements for working papers in audit engagements. First, you will study the authoritative literature on working papers. Next, you will consider the review process, including the concept of review, the different types of working papers, the mechanics of review, and the specific accounts to be reviewed. The chapter closes with the need to document the review process.

AU-C section 230, *Audit Documentation*,<sup>1</sup> establishes the basic documentation requirements in GAAS. Because it sets the basic working paper ground rules, it has been reproduced in this workbook as appendix A to chapter 1.

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<sup>1</sup> All AU-C sections can be found in AICPA *Professional Standards*.

# Audit standards affecting working paper content

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## AU-C Section 230

AU-C section 230 requires the auditor to prepare and maintain working papers on every audit. It says that the form and content of working papers should be designed to meet the circumstances of the particular audit engagement, but working papers should be sufficient to

- provide a clear understanding of the
  - nature, timing, and extent of auditing procedures applied;
  - results of the auditing procedures;
  - evidence obtained and its source;
  - significant findings and conclusions reached; and
  - significant professional judgments made in reaching those conclusions; and
- indicate who performed and reviewed the work and when the work was performed and reviewed.

Although the level of detail to be provided is a matter of the auditor's professional judgment, the documentation should be sufficiently detailed that an experienced auditor with no previous connection to the audit can understand the scope and results of the work, the conclusions reached, and that the financial statements agree or reconcile to the underlying accounting records.

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## Other guidance

The following AU-C sections establish specific matters that have to be documented. The following is an overview of their provisions:

AU-C Section	Documentation requirement
<b>Financial statement audits</b>	
AU-C section 230, <i>Audit Documentation</i>	<ul style="list-style-type: none"><li>▪ Identifying characteristics of the specific items or matters tested</li><li>▪ Abstracts or copies of significant contracts or agreements inspected</li><li>▪ The nature of significant findings or significant issues discussed with management, those charged with governance, or others, along with when and with whom the discussions took place</li><li>▪ How information inconsistent with the auditor's final conclusion regarding a significant finding was addressed</li></ul>

AU-C Section	Documentation requirement
	<ul style="list-style-type: none"> <li>▪ The justification for any departure from a relevant presumptively mandatory requirement and how the procedures applied instead were sufficient to achieve the requirement's intent</li> <li>▪ For any new or additional audit procedures or new conclusion after the auditor's report date: <ul style="list-style-type: none"> <li>– The circumstances involved</li> <li>– The new or additional procedures or new conclusion and the effect on the report</li> <li>– When and by whom the change was made and reviewed</li> </ul> </li> <li>▪ The date of the report release</li> <li>▪ Completion of the audit file no later than 60 days following the report release date</li> </ul>
AU-C section 210, <i>Terms of Engagement</i>	<ul style="list-style-type: none"> <li>▪ An engagement letter from the client</li> <li>▪ When using an engagement letter executed in a prior year, a reminder to the client about the terms of the engagement when the terms have not changed, or issue a new letter if they have</li> </ul>
AU-C section 220, <i>Quality Control for an Engagement Conducted in Accordance With GAAS</i>	<ul style="list-style-type: none"> <li>▪ Considerations and conclusions regarding compliance with ethics requirements including independence and how they were resolved</li> <li>▪ Conclusions reached about engagement acceptance or continuance</li> <li>▪ Consultations undertaken during the course of the engagement, the nature and scope of, and conclusions reached</li> <li>▪ The engagement quality control reviewer's procedures and conclusions</li> </ul>
AU-C section 240, <i>Consideration of Fraud in a Financial Statement Audit</i>	<ul style="list-style-type: none"> <li>▪ The auditor's consideration of the risk of fraud</li> <li>▪ Identified fraud risks</li> <li>▪ The responses to fraud risks and their results</li> <li>▪ Communications about fraud made to the entity</li> <li>▪ Any conclusion overcoming the presumption that revenue recognition is a fraud risk</li> </ul>
AU-C section 250, <i>Consideration of Laws and Regulations in a Financial Statement Audit</i>	<ul style="list-style-type: none"> <li>▪ Identified or suspected noncompliance with laws or regulations</li> <li>▪ The result of discussions with the client or others</li> </ul>
AU-C section 260, <i>The Auditor's Communication With Those Charged With Governance</i>	<ul style="list-style-type: none"> <li>▪ Required communications made orally, including when and to whom they were made</li> <li>▪ The retention of those made in writing</li> </ul>
AU-C section 265, <i>Communicating Internal Control Related Matters Identified in an Audit</i>	<ul style="list-style-type: none"> <li>▪ Any oral communications of control weaknesses not considered significant deficiencies or material weaknesses</li> </ul>

AU-C Section	Documentation requirement
AU-C section 300, <i>Planning an Audit</i>	<ul style="list-style-type: none"> <li>▪ The overall audit strategy</li> <li>▪ The audit plan</li> <li>▪ Any significant changes to the strategy or the plan made during the audit and the reason for the change</li> </ul>
AU-C section 315, <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i>	<ul style="list-style-type: none"> <li>▪ The required discussion among the engagement team regarding the financial statements' susceptibility to misstatement, including the significant decisions reached, how and when the discussion occurred, and who participated</li> <li>▪ Key points of each element of the understanding of the entity and its environment, the sources of the information, and the risk assessment procedures applied</li> <li>▪ Risks of material misstatement at the financial statement and relevant assertion levels</li> <li>▪ Significant risks and related controls</li> </ul>
AU-C section 320, <i>Materiality in Planning and Performing an Audit</i>	<ul style="list-style-type: none"> <li>▪ Materiality for the financial statements as a whole</li> <li>▪ Any materiality levels determined for particular items in the financial statements</li> <li>▪ Performance materiality</li> <li>▪ Any revision of materiality amounts</li> </ul>
AU-C section 330, <i>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</i>	<ul style="list-style-type: none"> <li>▪ The responses to risks of material misstatement at the financial statement and relevant assertion level and the results of those procedures (including the conclusions if not otherwise clear)</li> <li>▪ Conclusions reached about using tests of controls performed in a prior year, when the auditor decides to do so</li> <li>▪ The basis for any decision not to confirm accounts receivable when they are material</li> <li>▪ That the financial statements agreed with or reconcile to the financial records</li> </ul>
AU-C section 450, <i>Evaluation of Misstatements Identified During the Audit</i>	<ul style="list-style-type: none"> <li>▪ The amount below which misstatements would be considered clearly trivial</li> <li>▪ All misstatements accumulated during the audit and whether they were corrected</li> <li>▪ The auditor's conclusion about whether uncorrected misstatements are material individually or in the aggregate</li> <li>▪ The basis for that conclusion</li> </ul>
AU-C section 501, <i>Audit Evidence – Specific Considerations for Selected Items</i>	<ul style="list-style-type: none"> <li>▪ The basis for any decision not to communicate with legal counsel when a potential for a material misstatement due to litigation, claims, or assessments exists</li> </ul>
AU-C section 520, <i>Analytical Procedures</i>	<ul style="list-style-type: none"> <li>▪ The expectations used in analytical procedures (and unless otherwise readily determinable, the basis for them)</li> <li>▪ Results of the comparison between recorded amounts and expectations</li> <li>▪ Any additional audit procedures regarding investigation of unexpected differences and their results</li> </ul>

AU-C Section	Documentation requirement
AU-C section 540, <i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i>	<ul style="list-style-type: none"> <li>▪ Accounting estimates that represent significant risks</li> <li>▪ The basis for the auditor's conclusion about the reasonableness of their amounts and disclosures</li> <li>▪ Any indicators of possible management bias</li> </ul>
AU-C section 550, <i>Related Parties</i>	<ul style="list-style-type: none"> <li>▪ The names of identified related parties</li> <li>▪ The nature of the relationships</li> </ul>
AU-C section 570, <i>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i>	<ul style="list-style-type: none"> <li>▪ Conditions or events indicating a going concern</li> <li>▪ The elements of management's plans that are significant to overcoming the issue</li> <li>▪ The auditor's procedures to evaluate management's plans</li> <li>▪ The auditor's conclusion about whether substantial doubt remains and the effect on the financial statements and adequacy of disclosures</li> <li>▪ The auditor's conclusion regarding the effect on the audit report</li> </ul>
AU-C section 600, <i>Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)</i>	<ul style="list-style-type: none"> <li>▪ For all group audits: <ul style="list-style-type: none"> <li>– An analysis of components indicating which are significant and the type of work performed on the components</li> <li>– The components for which reference to the component auditor will be made in the audit report on the group financial statements</li> <li>– Written communications with the component auditors about the group auditor's requirements</li> <li>– The financial statements and auditor's report for any components for which reference to the component auditor will be made in the group auditor's report and when the component auditor's report doesn't state conformity with GAAS or PCAOB standards, the basis for the group auditor's determination that the work complied with relevant requirements of GAAS.</li> </ul> </li> <li>▪ When the group auditor assumes responsibility for the component auditor's work: <ul style="list-style-type: none"> <li>– The nature, timing, and extent of the group engagement team's involvement in the component auditor's work on significant components</li> <li>– Any review of the component auditor's documentation and the resulting conclusions</li> </ul> </li> </ul>
AU-C section 610, <i>Using the Work of Internal Auditors</i>	<ul style="list-style-type: none"> <li>▪ When using the work of the internal audit function in obtaining audit evidence <ul style="list-style-type: none"> <li>– The results of the evaluation of the function's objectivity, competence, and application of a systematic and disciplined approach,</li> <li>– The nature and extent of the work used and the basis for the decision to use it,</li> <li>– The audit procedures used to evaluate the adequacy of the work used.</li> </ul> </li> </ul>

AU-C Section	Documentation requirement
	<ul style="list-style-type: none"> <li>▪ When using internal auditors to provide direct assistance <ul style="list-style-type: none"> <li>– The evaluation of the objectivity and competence of the internal auditors providing direct assistance,</li> <li>– The basis for the decision regarding the nature and extent of their work,</li> <li>– The nature and extent of the auditor's review of their work, and</li> <li>– The working papers prepared by internal auditors providing direct assistance.</li> </ul> </li> <li>▪ In either case, the evaluation of whether the auditor is sufficiently involved in the audit given the auditor's sole responsibility for the audit opinion.</li> </ul>
Other Services Provided Under Statements on Auditing Standards	
AU-C section 915, <i>Reports on the Application of Requirements of an Applicable Financial Reporting Framework</i>	<ul style="list-style-type: none"> <li>▪ The rationale for when the reporting accountant does not consult with the continuing accountant</li> </ul>
AU-C section 930, <i>Interim Financial Information</i>	<ul style="list-style-type: none"> <li>▪ The nature, timing, and extent of review procedures performed</li> <li>▪ The results of the procedures and evidence obtained</li> <li>▪ Significant findings or issues that arose and the conclusions reached on them, including professional judgments made</li> <li>▪ Oral and written communications required by the standard</li> </ul>

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## Knowledge check

1. Which statement does NOT properly describe working papers?
  - a. They are required in every audit engagement.
  - b. There are no GAAS requirements for working paper form or content.
  - c. They demonstrate evidence of conformity with auditing standards.
  - d. They describe the nature, timing, and extent of audit procedures applied.
2. Who decides how much detail the working papers contain?
  - a. The AICPA.
  - b. The client.
  - c. The auditor.
  - d. Peer reviewers.

# What Information must working papers provide?

Documentation should be prepared for any procedures that provide audit evidence necessary to support the opinion. If the documentation is insufficient, the audit is not in accordance with GAAS even if appropriate testing was done.

The quantity, type, and content of working papers depend on the degree of evidential matter the auditor thinks is necessary to support the opinion on the client's financial statements. The auditor's judgment is tempered by

- the nature of the audit;
- the nature of the audit report;
- the nature of the financial statements, schedules, or other information on which he or she is reporting;
- the nature and condition of the client's records;
- the assessed level of control risk; and
- the needs in the particular circumstances for supervision and review of the work performed by assistants.

Important questions the senior should consider in reviewing working papers are whether the working papers show

- the amounts in the financial statements represent the amounts in the company's books and records;
- the application of the audit strategy and audit program for significant amounts;
- the required understanding of the client and its internal control;
- each of the material amounts in the financial statements has been tested;
- tests applied, evidence obtained, and any discrepancies or deviations encountered; and
- clerical aspects of working paper preparation, such as descriptions of working papers, dates and initials of the preparer, sources of data, and mathematical accuracy of schedules received from the client.

# Structural elements of working paper files

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## Permanent files or carryforward files

These files contain material related to aspects of the audit that would not be expected to change significantly from year to year. This could include such background information as

- the nature of the client's business operations;
- details of important relationships the client may have with outsiders;
- excerpts from, or copies of, meeting minutes and important legal documents, such as contracts, loan agreements, the corporate charter, or partnership agreement; and
- the organization of the financial accounting and reporting system.

The files may also contain comparative analyses of client financial performance and carryforward analyses of key accounts.

The in-charge generally has an understanding of the contents of the permanent files and ensures that they have been appropriately updated during the current audit.

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## General matters files

These files contain material relating specifically to the current year's audit, but do not directly reflect any of the actual account verification or systems testing work performed. They may include such items as

- correspondence with the client and outside experts;
- information concerning significant changes made during the current year;
- copies of financial statements;
- planning data, such as assessments of materiality and risk, sensitive areas subject to fraud risks and strategy and conclusion memos;
- details supporting any adjustments, exceptions, or the resolution of unusual items; and
- documentation of required communications.

The in-charge should make sure that issues, findings, and conclusions identified in the specific accounts files are summarized or reflected in the general matters file so that the partner is aware of them in making decisions about the audit and the financial statements.

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## Specific accounts files

Specific accounts files contain the working papers prepared during the current year that relate to account balance verification and systems testing. They are the critical groundwork on which the auditor bases the opinion of whether the client's financial statements conform to generally accepted accounting principles (or "Special Purpose Framework" regulations).



These files are the guts of the audit. They document the nature, timing, and extent of procedures applied, the evidence obtained, and identification of misstatements detected.

The in-charge's focus is on making sure the tests applied are those called for in the audit plan and the findings are clearly documented so that the more senior staff, including the partner, can consider them appropriately in determining the adequacy of the audit and whether the amounts in the financial statements are suitably supported and in conformity with generally accepted accounting principles (GAAP).

# Levels of review

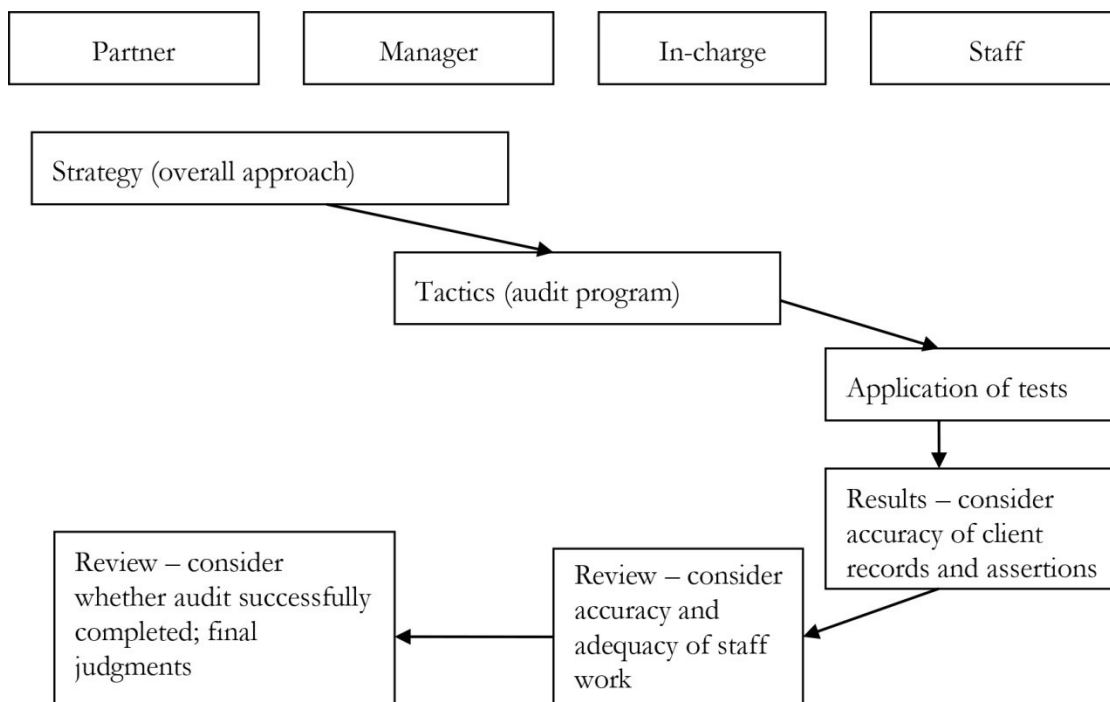
To gain a good perspective of working papers review, let us consider the levels of working papers review.

Although the number of reviews and the level at which they are performed can vary from firm to firm and audit to audit, the underlying objectives remain the same. There might be three levels of review:

1. The in-charge accountant's review
2. The manager's or partner's review
3. The independent review (also known as the engagement quality control review or second partner review).

On larger audits there might be several people reviewing working papers. For example, a detailed review might first be performed by staff auditors below the in-charge level. However, the goals of the reviews generally fall into these three categories.

In order to understand the goal of the working paper review, it is useful to consider the functions of the various participants in the audit. The following is a general model. Keep in mind that the distinctions are somewhat arbitrary. For example, the in-charge or staff might be involved in strategy determination although the responsibility for it is generally at a higher level. Similarly, the in-charge might apply audit tests that would be reviewed by the manager.



The determination of strategy and final decisions for the audit fall to the partner, yet the detailed work is done by the staff. The working paper reviews are the critical link to communicate the staff's findings to the partner making the decision. The in-charge accountant's review is the critical step or control to make

sure the work and observations are appropriately communicated so that decisions are based on the work actually done.

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## The in-charge accountant's review

The in-charge accountant's review includes, but is not limited to, a detailed review of audit programs, evidence obtained, understanding of internal control, reports and the management letter. The point of the review is to ensure the work is complete and documented. The in-charge is concerned primarily with making sure

- the audit plan (that is, the audit program) has been complied with;
- the evidence obtained supports the amounts; and
- any differences are adequately identified.

That is, do the tests accomplish what they intended and purport to do? Are differences and unusual or unexpected items clearly identified for the manager and partner to consider?

This review usually generates a list of items for staff follow-up. The focus of this course is on the in-charge accountant's review.

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## The partner's or manager's review

The partner's or manager's review includes, but is not limited to, a detailed review of the financial statements, disclosures, and auditor's report. Because preparers of working papers should not do the final review of their own work, the manager's or partner's review should include a detailed check of any working papers that the in-charge accountant prepares.

Generally, this review focuses more on the summary and evaluation schedules and less on supporting working paper schedules. Often, it is conducted after financial statements and the audit report have been drafted and is the final check on whether the audit work supports the overall conclusions on the financial statements.

When a manager has already reviewed the working papers, the partner's review generally focuses on high-level decisions and unusual matters of accounting practice and procedure.

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## Independent reviews

Independent reviews are undertaken internally by the CPA firm to ensure that the personnel in each of its offices are performing engagements that conform to general professional standards and to the firm's own quality standards. The larger the firm, the larger and more elaborate the organization will be that performs this function.

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Firms are required by quality control standards to monitor the quality of the firms' audit practices. Such reviews generally take place after the audit report has been issued.

In addition, many firms do quality control reviews, also called second-partner or independent-partner reviews, of engagements before the report is issued. These reviews might be done on all engagements or limited to clients with certain characteristics, such as those that are publicly held or pose particular risk due to their size or nature of their business. Quality control standards do not require second-partner reviews in any specific circumstance, but SQCS No. 8, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10) requires firms to establish criteria for determining whether an engagement is subject to second-partner review and the criteria for performing the review. It requires the review to include reviewing selected engagement documentation relating to significant judgments the engagement team made and the conclusions they reached and discussion with the engagement partner regarding significant findings and issues.

The second-partner review is generally less extensive than the primary partner's review. It generally involves considering

- the audit team's identification and responses to significant risks;
- judgments made, particularly with respect to regarding materiality and significant risks;
- significant auditing, accounting, and financial reporting matters;
- matters required to be communicated with those charged with governance;
- audit findings or issues that are significant, including actions taken to address them, and the basis for the final conclusions reached: this generally involves reading the audit strategy memo, audit program for significant areas, summary memo (if prepared), and working papers the second partner deems necessary to review;
- the resolution of matters involved in consultations or reviewing documentation of such consultation;
- the summary of uncorrected financial statement misstatements;
- the financial statements and auditors' report; and
- whether there are any significant unresolved matters.

SQCS No. 8 requires the firm to appropriately document the review, including documentation that

- the procedures required by the firm's policies have been performed;
- the review has been completed before the report is released; and
- the reviewer is not aware of any unresolved matters that would cause the reviewer to believe the significant judgments the engagement team made and conclusions they reached were not appropriate.

In addition, outsiders – such as peer reviewers (or the PCAOB, for public company audit engagements) – may review the working papers. These reviews can be very detailed, so the working papers need to be adequate for reviews done by persons outside the firm with no knowledge of the client done perhaps years after the completion of the audit.

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## Knowledge check

3. Which working paper review generally includes a detailed review of audit programs, evidence obtained, understanding of internal control, reports, and the management letter?
- The partner's review.
  - The in-charge accountant's review.
  - The staff accountant's review.
  - The independent reviewer's review.

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## Benefits of the review

The primary benefits of the review are to ensure that (1) the audit staff successfully carried out the audit strategy, (2) the results of the work have been recorded and, (3) the significant matters communicated to the partner making the final decisions about whether GAAS and GAAP have been complied with.

Additional reasons review of audit working papers is highly worthwhile, include

- determining that there are no unanswered questions and that the working papers contain adequate documentation to support the work done, the conclusions reached, and the proposed report;
- eliminating unsupported, contradictory, unnecessary, or embarrassing comments;
- determining whether additional audit work may be necessary to satisfy the requirements of the guidelines;
- determining whether the audit was efficient, and whether the firm's staff and the client's personnel performed or contributed effectively;
- improving on the job training of audit staff as well as to evaluate their competence;
- better preparing the in charge auditor, the manager or the firm partner for post audit and pre opinion discussions with the client;
- helping plan next year's audit, budget, and fee; and
- getting the benefit of an additional point of view (the reviewer's) about the audit work done.

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## Completion of the audit file

AU-C section 230 requires that the audit documentation be accumulated into an audit file within 60 days of the report release date. The documentation has to be retained for at least 5 years and the confidentiality of client information needs to be maintained. No items should be deleted from the file during the retention period. Additionally, any changes to audit documentation after the documentation has been assembled must indicate the reason for the change and when and by whom the changes were made.

# Summary

This section discussed

- the documentation requirements established by GAAS;
- the structure of working paper files; and
- how the levels of review fit together to ensure an effective audit.

## Appendix A

# **AU-C SECTION 230, AUDIT DOCUMENTATION**

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This appendix is included for supplementary purposes only and is not required for CPE credit.





# AU-C Section 230

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## Audit documentation

Source: SAS No. 122; SAS No. 123; SAS No. 128.

See section 9230 for interpretations of this section.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

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## Introduction

### Scope of this section

- .01 This section addresses the auditor's responsibility to prepare audit documentation for an audit of financial statements. The exhibit, "Audit Documentation Requirements in Other AU-C Sections," lists other AU-C sections that contain specific documentation requirements and guidance. The specific documentation requirements of other AU-C sections do not limit the application of this section. Law, regulation, or other standards may establish additional documentation requirements.

### Nature and purposes of audit documentation

- .02 Audit documentation that meets the requirements of this section and the specific documentation requirements of other relevant AU-C sections provides
- a. evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor;<sup>1</sup> and
  - b. evidence that the audit was planned and performed in accordance with generally accepted auditing standards (GAAS) and applicable legal and regulatory requirements.
- .03 Audit documentation serves a number of additional purposes, including the following:
- Assisting the engagement team to plan and perform the audit
  - Assisting members of the engagement team responsible for supervision to direct and supervise the audit work and to discharge their review responsibilities in accordance with section 220, Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards<sup>2</sup>
  - Enabling the engagement team to demonstrate that it is accountable for its work by documenting the procedures performed, the audit evidence examined, and the conclusions reached

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<sup>1</sup> Paragraph .12 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

<sup>2</sup> Paragraphs .17–.19 of section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.

- Retaining a record of matters of continuing significance to future audits of the same entity
- Enabling the conduct of quality control reviews and inspections in accordance with QC section 10, *A Firm's System of Quality Control*
- Enabling the conduct of external inspections or peer reviews in accordance with applicable legal, regulatory, or other requirements
- Assisting an auditor who reviews a predecessor auditor's audit documentation
- Assisting auditors to understand the work performed in the prior year as an aid in planning and performing the current engagement

## Effective date

- .04 This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

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## Objective

- .05 The objective of the auditor is to prepare documentation that provides
- a. a sufficient and appropriate record of the basis for the auditor's report; and
  - b. evidence that the audit was planned and performed in accordance with GAAS and applicable legal and regulatory requirements.

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## Definitions

- .06 For purposes of GAAS, the following terms have the meanings attributed as follows:

**Audit documentation.** The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as *working papers* or *workpapers* are also sometimes used).

**Audit file.** One or more folders or other storage media, in physical or electronic form, containing the records that constitute the audit documentation for a specific engagement.

**Documentation completion date.** The date, no later than 60 days following the report release date, on which the auditor has assembled for retention a complete and final set of documentation in an audit file.

**Experienced auditor.** An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of (Ref: par. .A1)

- a. audit processes;
- b. GAAS and applicable legal and regulatory requirements;
- c. the business environment in which the entity operates; and
- d. auditing and financial reporting issues relevant to the entity's industry.

**Report release date.** The date the auditor grants the entity permission to use the auditor's report in connection with the financial statements. (Ref: par. .A2)

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## Requirements

### Timely preparation of audit documentation

.07 The auditor should prepare audit documentation on a timely basis. (Ref: par. .A3)

### Documentation of the audit procedures performed and audit evidence obtained

#### Form, content, and extent of audit documentation

- .08 The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand (Ref: par. .A4–.A7 and .A19–.A20)
- a.* the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements; (Ref: par. .A8–.A9)
  - b.* the results of the audit procedures performed, and the audit evidence obtained; and
  - c.* significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: par. .A10–.A13)
- .09 In documenting the nature, timing, and extent of audit procedures performed, the auditor should record
- a.* the identifying characteristics of the specific items or matters tested; (Ref: par. .A14)
  - b.* who performed the audit work and the date such work was completed; and
  - c.* who reviewed the audit work performed and the date and extent of such review. (Ref: par. .A15)
- .10 For audit procedures related to the inspection of significant contracts or agreements, the auditor should include abstracts or copies of those contracts or agreements in the audit documentation.
- .11 The auditor should document discussions of significant findings or issues with management, those charged with governance, and others, including the nature of the significant findings or issues discussed, and when and with whom the discussions took place. (Ref: par. .A16)
- .12 If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant finding or issue, the auditor should document how the auditor addressed the inconsistency. (Ref: par. .A17–.A18)

#### Departure from a relevant requirement

- .13 If, in rare circumstances, the auditor judges it necessary to depart from a relevant presumptively mandatory requirement,<sup>3</sup> the auditor must document the justification for the departure and how the alternative audit procedures performed in the circumstances were sufficient to achieve the intent of that requirement. (Ref: par. .A21–.A22)

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<sup>3</sup> Paragraph .26 of section 200.

## **Matters arising after the date of the auditor's report**

- .14** If, in rare circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor should document (Ref: par. .A23)
- a.* the circumstances encountered;
  - b.* the new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
  - c.* when and by whom the resulting changes to audit documentation were made and reviewed.

## **Assembly and retention of the final audit file**

- .15** The auditor should document the report release date in the audit documentation.
- .16** The auditor should assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis, no later than 60 days following the report release date. (Ref: par. .A24–.A26)
- .17** After the documentation completion date, the auditor should not delete or discard audit documentation of any nature before the end of the specified retention period. Such retention period, however, should not be shorter than five years from the report release date. (Ref: par. .A27–.A29)
- .18** In circumstances other than those addressed in paragraph .14 in which the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the documentation completion date, the auditor should, regardless of the nature of the modifications or additions, document (Ref: par. .A28)
- a.* the specific reasons for making the changes; and
  - b.* when and by whom they were made and reviewed.
- .19** The auditor should adopt reasonable procedures to maintain the confidentiality of client information.

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## **Application and other explanatory material**

### **Definitions (Ref: par. .06)**

#### **Experienced auditor**

- .A1** Having practical audit experience means possessing the competencies and skills that would have enabled the auditor to perform the audit but does not mean that the auditor is required to have performed comparable audits.

## Report release date

- .A2** In many cases, the report release date will be the date the auditor delivers the audit report to the entity. When there are delays in releasing the report, a fact may become known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to revise the auditor's report. Section 560, *Subsequent Events and Subsequently Discovered Facts*, addresses the auditor's responsibilities in such circumstances, and paragraph .14 addresses the documentation requirements in the rare circumstances in which the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report.

## Timely preparation of audit documentation (Ref: par. .07)

- .A3** Preparing sufficient and appropriate audit documentation on a timely basis throughout the audit helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared at the time such work is performed or shortly thereafter is likely to be more accurate than documentation prepared at a much later time.

## Documentation of the audit procedures performed and audit evidence obtained

### Form, content, and extent of audit documentation (Ref: par. .08)

- .A4** The form, content, and extent of audit documentation depend on factors such as
- the size and complexity of the entity.
  - the nature of the audit procedures to be performed.
  - the identified risks of material misstatement.
  - the significance of the audit evidence obtained.
  - the nature and extent of exceptions identified.
  - the need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
  - the audit methodology and tools used.
  - the extent of judgment involved in performing the work and evaluating the results.
- .A5** Audit documentation may be recorded on paper or on electronic or other media. QC section 10 addresses a firm's responsibility to establish procedures designed to maintain the integrity, accessibility, and retrievability of documentation; for example, when original paper documentation is electronically scanned or otherwise copied to another media for inclusion in the audit file.<sup>4</sup> Examples of audit documentation include the following:
- Audit plans<sup>5</sup>
  - Analyses
  - Issues memorandums
  - Summaries of significant findings or issues
  - Letters of confirmation and representation
  - Checklists
  - Correspondence (including email) concerning significant findings or issues

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<sup>4</sup> Paragraph .A58 of QC section 10, *A Firm's System of Quality Control*.

<sup>5</sup> Paragraphs .07–.11 of section 300, *Planning an Audit*.

- .A6 The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.
- .A7 On their own, oral explanations by the auditor do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

#### Documentation of compliance with GAAS (Ref: par. .08a)

- .A8 In principle, compliance with the requirements of this section will result in the audit documentation being sufficient and appropriate in the circumstances. Other AU-C sections contain specific documentation requirements that are intended to clarify the application of this section in the particular circumstances of those other AU-C sections. The specific documentation requirements of other AU-C sections do not limit the application of this section. Furthermore, the absence of a documentation requirement in any particular AU-C section is not intended to suggest that there is no documentation that will be prepared as a result of complying with that AU-C section.
- .A9 Audit documentation provides evidence that the audit complies with GAAS. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:
- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
  - The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed to the terms of the audit engagement with management or, when appropriate, those charged with governance.
  - An auditor's report containing an appropriately qualified opinion on the financial statements demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances in accordance with GAAS.
  - Regarding requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
    - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with GAAS. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.
    - Similarly, that the engagement partner has taken responsibility for the direction, supervision, and performance of the audit in compliance with GAAS may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussions required by section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.<sup>6</sup>

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<sup>6</sup> Paragraph .33 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

**Documentation of significant findings or issues and related significant professional judgments (Ref: par. .08c)**

- .A10** Judging the significance of a finding or issue requires an objective analysis of the facts and circumstances. Examples of significant findings or issues include
- matters involving the selection, application, and consistency of significant accounting practices, including related disclosures. Such matters include, but are not limited to (a) accounting for complex or unusual transactions or (b) accounting estimates and uncertainties and, if applicable, the related management assumptions.
  - matters that give rise to significant risks (as defined in section 315).<sup>7</sup>
  - results of audit procedures (including identification of corrected and uncorrected misstatements)<sup>8</sup> indicating (a) that the financial statements could be materially misstated or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
  - circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
  - findings that could result in a modification to the audit opinion or the inclusion of an emphasis-of-matter paragraph in the auditor's report.
- .A11** An important factor in determining the form, content, and extent of audit documentation of significant findings or issues is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, when significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such findings or issues are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits when reviewing items of continuing significance (for example, when performing a retrospective review of accounting estimates).
- .A12** Some examples of circumstances in which, in accordance with paragraph .08, it is appropriate to prepare audit documentation relating to the exercise of professional judgment include, when the findings, issues, and judgments are significant,
- the rationale for the auditor's conclusion when a requirement provides that the auditor *should consider* certain information or factors, and that consideration is significant in the context of the particular engagement.
  - the basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
  - the basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of a specialist or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.
- .A13** The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant findings or issues identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such

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<sup>7</sup> Paragraphs .28–.30 of section 315.

<sup>8</sup> See section 450, *Evaluation of Misstatements Identified During the Audit*.

information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant findings or issues. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant AU-C section objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

**Identification of specific items or matters tested and of the preparer and the reviewer (Ref: par. .09)**

**.A14** Recording the identifying characteristics serves a number of purposes. For example, it improves the ability of the auditor to supervise and review the work performed and thus demonstrates the accountability of the engagement team for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:

- For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register for the period being audited).
- For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point, and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period from April 1 to September 30, starting with report number 12345 and selecting every 125th report).
- For a procedure requiring inquiries of specific entity personnel, the auditor may record the inquiries made, the dates of the inquiries, and the names and job designations of the entity personnel.
- For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

**.A15** Section 220 requires the auditor to review the audit work performed through review of the audit documentation.<sup>9</sup> The requirement to document who reviewed the audit work performed and the extent of the review, in accordance with the firm's policies and procedures addressing review responsibilities, does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

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<sup>9</sup> Paragraph .19 of section 220.



**Documentation of discussions of significant findings or issues with management, those charged with governance, and others (Ref: par. .11)**

- .A16** The audit documentation is not limited to documents prepared by the auditor but may include other appropriate documents such as minutes of meetings prepared by the entity's personnel and recognized by the auditor as an appropriate summary of the meeting. Others with whom the auditor may discuss significant findings or issues may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

**Documentation of how inconsistencies have been addressed (Ref: par. .12)**

- .A17** The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.
- .A18** The documentation of the inconsistency may include, but is not limited to, procedures performed in response to the information, and documentation of consultations on, or resolutions of, differences in professional judgment among members of the engagement team or between the engagement team and others consulted.

**Considerations specific to smaller, less complex entities (Ref: par. .08)**

- .A19** The audit documentation for the audit of a smaller, less complex entity is generally less extensive than that for the audit of a larger, more complex entity. Further, in the case of an audit in which the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team (for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement in paragraph .08 to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.
- .A20** When preparing audit documentation, the auditor of a smaller, less complex entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller, less complex entity include the understanding of the entity and its internal control; the overall audit strategy and audit plan; materiality; assessed risks, significant findings or issues noted during the audit; and conclusions reached.

**Departure from a relevant requirement (Ref: par. .13)**

- .A21** The requirements of GAAS are designed to enable the auditor to achieve the objectives specified in GAAS, and thereby the overall objectives of the auditor. Accordingly, other than in rare circumstances, GAAS call for compliance with each requirement that is relevant in the circumstances of the audit.

- .A22** The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant<sup>10</sup> only in the cases in which
- a. the AU-C section is not relevant (for example, if an entity does not have an internal audit function, nothing in section 610, Using the Work of Internal Auditors, is relevant); or
  - b. the requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion when there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

### **Matters arising after the date of the auditor's report (Ref: par. .14)**

- .A23** Examples of rare circumstances in which the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report include
- when, after the date of the auditor's report, the auditor becomes aware of facts that existed at that date and which, if known at that date, might have caused the financial statements to be revised or the auditor to modify the opinion in the auditor's report.<sup>11</sup>
  - when the auditor concludes that procedures necessary at the time of the audit, in the circumstances then existing, were omitted from the audit of the financial information.<sup>12</sup>

The resulting changes to the audit documentation are reviewed in accordance with the firm's quality control procedures as required by QC section 10.

### **Assembly and retention of the final audit file (Ref: par. .16–.18)**

- .A24** Statutes, regulations, or the audit firm's quality control policies may specify a period of time shorter than 60 days following the report release date in which this assembly process is to be completed.
- .A25** Certain matters, such as auditor independence and staff training, which are not engagement specific, may be documented either centrally within a firm or in the audit documentation for an audit engagement.
- .A26** The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include
- deleting or discarding superseded documentation.
  - sorting, collating, and cross-referencing working papers.
  - signing off on completion checklists relating to the file assembly process.
  - documenting audit evidence that the auditor has obtained, discussed, and agreed with the relevant members of the engagement team before the date of the auditor's report.
  - adding information received after the date of the auditor's report; for example, an original confirmation that was previously faxed.

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<sup>10</sup> Paragraph .24 of section 200.

<sup>11</sup> Paragraphs .12 and .15 of section 560, Subsequent Events and Subsequently Discovered Facts.

<sup>12</sup> Paragraph .07 of section 585, Consideration of Omitted Procedures After the Report Release Date.

- .A27 Firms are required to establish policies and procedures for the retention of engagement documentation.<sup>13</sup> Statutes, regulations, or the audit firm's quality control policies may specify a retention period longer than five years.
- .A28 An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after the documentation completion date is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.
- .A29 Audit documentation is the property of the auditor, and some states recognize this right of ownership in their statutes. The auditor may make available to the entity at the auditor's discretion copies of the audit documentation, provided such disclosure does not undermine the effectiveness and integrity of the audit process.

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## Exhibit – audit documentation requirements in other AU-C Sections

- .A30 The following lists the main paragraphs in other AU-C sections that contain specific documentation requirements. This list is not a substitute for knowledge of the AU-C sections:
- a. Paragraphs .10, .13, and .16 of section 210, *Terms of Engagement*
  - b. Paragraphs .25–.26 of section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*
  - c. Paragraphs .43–.46 of section 240, *Consideration of Fraud in a Financial Statement Audit*
  - d. Paragraph .28 of section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*
  - e. Paragraph .20 of section 260, *The Auditor's Communication With Those Charged With Governance*
  - f. Paragraph .12 of section 265, *Communicating Internal Control Related Matters Identified in an Audit*
  - g. Paragraph .14 of section 300, *Planning an Audit*
  - h. Paragraph .33 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
  - i. Paragraph .14 of section 320, *Materiality in Planning and Performing an Audit*
  - j. Paragraphs .30–.33 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
  - k. Paragraph .12 of section 450, *Evaluation of Misstatements Identified During the Audit*
  - l. Paragraph .20 of section 501, *Audit Evidence—Specific Considerations for Selected Items*
  - m. Paragraph .08 of section 520, *Analytical Procedures*
  - n. Paragraph .22 of section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*
  - o. Paragraph .28 of section 550, *Related Parties*
  - p. Paragraph .32 of section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

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<sup>13</sup> Paragraph .50 of QC section 10.

- q.* Paragraphs .49 and .64 of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*
- r.* Paragraph .13 of section 915, *Reports on Application of Requirements of an Applicable Financial Reporting Framework*
- s.* Paragraphs .42–.43 of section 930, *Interim Financial Information*
- t.* Paragraphs .39–.42 of section 935, *Compliance Audits*

[Revised, August 2012, to reflect conforming changes necessary due to the issuance of SAS No. 126.]



## Chapter 8

# Conducting the Review

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### Learning objectives

After completing this chapter, you should be able to do the following:

- Identify items you need to look for in reviewing working papers.
  - Recognize guidelines for the in-charge review.
  - Indicate how review findings are communicated.
- 

### Introduction

The objective of this chapter is to show you how to proceed with an actual review of working papers. It addresses the job of the reviewer and how to go about it.

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### What to look for in reviewing working papers

The in-charge review typically focuses on four broad areas:

- Form and content of the working papers
  - Completion of audit program steps
  - Accomplishment of audit objectives
  - Judgments made by the staff auditors
-

# Form and content of working papers

The most basic procedure is to read the working papers for appropriateness of form and content. In doing this, the in-charge looks for

- clarity,
- completeness,
- language, and
- firm standards.

The working papers need to be clear so that the reviewers understand precisely what the staff auditor did and what he or she found. Lack of clarity can result in the reviewer failing to detect and correct insufficient work or evidence indicating problems with financial statement items. If the staff does not catch it and it is not clear, you are not going to catch it either. The clarity check involves considering the following:

- Were the procedures applied clearly described?
- Were the findings clearly described or evident?

The in-charge is responsible for quality control over working paper preparation. This involves checking for the following:

- Is the working paper clerically complete?
- Does the working paper indicate the name of the client, balance sheet date, descriptive title of the working paper, name of preparer and date of preparation, source of data?
- Are cross references complete?
- Are there open items, such as documents expected (originals of faxed confirmations, for example) or tests that have not been completed?

Another aspect of quality control deals with the language used in working papers by staff auditors who are relatively inexperienced. The language should be professional and precise. The in-charge should ask the following questions:

- Is the language used in the working papers appropriate?
- Are conclusions supported by the work or are they overbroad?
- Are any observations undiplomatic?

Finally, the in-charge should make sure items such as the page numbering, indexing, and required sign-offs have been completed in accordance with the firm's internal standards.

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## Knowledge check

1. The working paper files given to the partner for review should ensure that all to-do lists
  - a. Are filed and indexed.
  - b. Are completed.
  - c. Are discarded.
  - d. Include open items.

# Completion of audit program steps

The audit strategy is implemented through the audit program (also called the “audit plan”). In planning the audit, the partner satisfies himself or herself that the audit program is sufficient to perform the audit. That is, in the absence of unexpected circumstances the partner should be satisfied that the audit is adequate if each step of the audit program is completed. Accordingly, the in-charge should review the working papers to see if all the steps in the audit program have actually been completed in accordance with the audit program.

This involves the following steps:

- Reviewing the audit program for appropriate sign-offs
- Comparing each audit program step to the test that purports to address it
- Making sure the scope of the test aligns with specified scope in the audit program
- Documenting any changes to the audit program
- Understanding the reasons for any additional work done

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## Reviewing the audit program for appropriate sign-offs

Most firms require that each audit program step be initialed to indicate the step has been completed. The in-charge should make sure each step in the area being reviewed has been signed off.

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## Comparing each audit program step to the test that purports to address it

For each audit program step, there should be some documentation about what was done and what was found. Ordinarily, the performance of each step and its result are described on a working paper and many firms require the audit program to cross-reference to the working paper that documents the test. Even if the firm does not require cross-referencing, the in-charge should review the working papers together with the audit program – that is, with both open in front of him or her – to make sure each step has been done.

For some procedures, a notation in the audit program rather than creating a separate working paper might be sufficient. For example, if the procedure is to inquire about a specific matter, the audit program might be annotated to indicate whom the auditor asked and the response. In that case, the in-charge should be satisfied the notation actually describes what the staff person did and found.

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## Making sure the scope of the test aligns with the specified scope in the audit program

The in-charge should be satisfied that the nature, timing, and extent of the test aligns with the approved audit program. If the audit program called for a sample of 50 items, the in-charge should be satisfied that 50 were tested.

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## Documenting any changes to the audit program

Occasionally, circumstances call for omitting, changing, or adding procedures to what was planned in the audit program. The in-charge should understand any changes and make sure they are documented so that the partner is aware of and approves changes to the plan.

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## Understanding the reasons for any additional work done

The in-charge should understand the purpose for any testing not called for by the audit program so that he or she can be satisfied that it achieved a relevant audit objective. This understanding is necessary to detect unnecessary or duplicative test work performed by the audit staff. For example, sometimes a unique situation during one year's audit requires a unique audit response that was not originally anticipated or included in the audit program. The same unique situation and response may not be required on a go-forward basis (for instance, in the following year). However, if a staff auditor uses the prior year's working papers as a model for their current year work, rather than the current year audit plan, they might unnecessarily perform unique tests.

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## Knowledge check

2. In becoming satisfied that the audit plan has been implemented, the in-charge accountant
  - a. May confine himself or herself to seeing that the audit program has been signed off.
  - b. Should compare the audit program to working paper documentation.
  - c. Should rely on the partner's review for this assurance.
  - d. May limit himself or herself to the audit plan sections related to the in-charge's own original work.



# Effectiveness of tests completed

The in-charge reviewer is the first line of control over the work done. He or she needs to make sure that the work has been done effectively. In effect, the reviewer should audit the work of the staff person. This does not mean that the reviewer needs to reperform all the work, but rather should selectively test the work through reviewing documentation in the working papers and, when necessary discussing the work with the staff member or looking at documents not included in the working papers. This accomplishes the following two things:

- *Checking that the work actually does what it purports to do.* Sometimes the staff auditor might misunderstand the goal of a procedure, the source of data, or the scope of the necessary evidence. In that case, an otherwise beautifully constructed working paper might not actually accomplish anything meaningful.
- Confirming the in-charge's understanding of the evidence obtained and the interrelationship of accounts or transactions.

Procedures the reviewer applies include the following:

- *Checking that amounts traced between working papers actually agree.* The staff person might have misunderstood the goal of the test or the significance of the data being used.
- *Considering whether the test involved the appropriate information sources.* For example, a test might indicate that the staff person looked at "support" but rather than relying on an independent source such as a vendor's invoice, he or she might have looked at a voucher or internal database that has not been tested for reliability.
- *Considering whether the population subject to testing was what was anticipated.* For example, the audit program might have presumed certain characteristics of the population such as size, homogeneity, or transactions giving rise to it that are no longer true. Applying the planned procedures, then, might not achieve the audit objectives.
- *Reperforming mathematical calculations.* It is often helpful to reperform some calculations to confirm the understanding of how amounts are arrived at and to make sure the working papers do not omit important information.
- *Considering evidence not included in the working papers.* Not all evidence used is copied into the working papers. It is often a good idea to discuss with the staff person the source of such information and what it actually contained.

# Judgments made by the staff

Because of the structure of most audit teams, the people closest to the detail are typically the least experienced. They also typically have less context and a narrower perspective in which to make judgments than their superiors. Accordingly, it is important for the in-charge to critically consider all the judgments explicitly or implicitly made by the staff auditors. Implicit judgments can be particularly difficult because, by definition, they are not clearly set out in the working papers.

Although staff auditors typically do not presume to make broad strategy decisions, seemingly minor conclusions such as the following deserve a second look by the in-charge reviewer:

- *Stability of balances in analytical procedures* – Often, when a balance is similar to the previous-year's balance, less-experienced staff conclude it is reasonable because there is no significant fluctuation. However, in many cases such a balance is related to some other financial statement or operating component that has significantly changed and thus should not be similar to the previous year.
- *No further work necessary* – A staff person might dismiss seemingly minor amounts or differences by concluding "immaterial," "reasonable," "consistent with previous year," or "no further work deemed necessary." Such conclusions should be scrutinized by the reviewer to make sure they are relevant and valid, particularly in view of work done by other staff members that the in-charge is aware of. Similarly, AU-C section 450, *Evaluation of Misstatements Identified During the Audit*,<sup>1</sup> warns that misstatements identified should not be presumed to be isolated occurrences.
- *Significance of new types of transactions or circumstances* – Because of a lack of experience or perspective on the engagement, the staff person might overlook the significance of issues not addressed in previous years. Unless they are noted in the working papers, it is less likely the partner will have a basis to consider their effect on the audit or the financial statements.
- *Conclusions about accounts tested* – Many firms call for explicit conclusions to be expressed on the working papers for each test applied. If a conclusion is expressed it should be consistent with the work done. So, for example, an account should preferably not be described as in conformity with generally accepted accounting principles (GAAP), as the auditor's tests are designed for the financial statements as a whole, not each account balance. A term such as "correct" similarly might be read out of context.
- *Weaknesses in internal control* – In obtaining an understanding of internal control, the staff person might encounter weaknesses that represent significant deficiencies or material weaknesses that need to be reported to those charged with governance. The reviewer should consider the internal controls documented and the results of tests applied to consider whether such control weaknesses are apparent even if not specifically identified by the staff person preparing the working paper.

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<sup>1</sup> All AU-C sections can be found in AICPA *Professional Standards*.

# General guidelines

Proper planning is important. Plan for the review and instruct your staff accountants as they begin to work in each area of the engagement. Consider their experience and training level and discuss the adequacy of prior years' working papers.

Prepare yourself to establish and maintain the proper mental attitudes: independence and objectivity. Make sure you thoroughly understand the client's business, accounting system, and so on. Acquaint yourself with any previous problem areas and keep the objectives of working papers in mind.

Give your assistants effective supervision as they work. Encourage them to review their own working papers before they turn them over to you.

Try to review any important and difficult areas early in the review, preferably in the morning, when you are fresh.

It is a good idea to review the working papers in the field when the staff is still there so that the staff can answer questions while the work is still fresh in their minds and any additional work can be done right away.

With the advent of electronic working papers, it is increasingly common for the reviewer to be in a location separate from the staff performing the work. There is a danger that the working paper preparer might be less sensitive to comments or questions not directed to him or her in person, resulting in less precision in the working papers. It might be a good idea in that circumstance to arrange to discuss the working papers telephonically if it is impractical for the in-charge reviewer to review the files on site.

Your goal must be to perform a review that is adequate to ensure that

- the work was adequately planned and supervised; and
- the work was responsive to, and accomplished the goals of, the audit programs.

Of course, this requires that there be appropriate audit programs that have been completed and signed off by the persons performing the work.

The review must ensure that

- the work done is sufficient to support the conclusion reached that the financial statements, taken as a whole, are free of material misstatements; and
- the work has been completed and open "to do's" or questions are identified and, ultimately, that all review comments have been adequately disposed of.

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## Knowledge check

3. Having staff auditors review their own work before giving it to the in-charge accountant for review is
  - a. Required.
  - b. A good idea.
  - c. Inefficient.
  - d. Prohibited.

# Specific guidelines

As a reviewer, you must insist that completed audit working papers are “reviewable” at all levels to determine the adequacy and effectiveness of the work performed:

- Only if papers give a clear and complete description of work performed as support for the accountant’s opinion or other applicable type of report, can the firm’s reviewers satisfy themselves that the assigned work was done properly.
- No work should be merely clerical.

Each section should be reviewed as a separate part, but you should know how they interrelate. For example, the tests of inventory and warranty expense might be done by different staff auditors and filed in separate sections of the working papers. But conclusions regarding warranty problems might indicate potential inventory valuation problems. Or, the revenue and expense working papers might indicate that tests of repairs and maintenance are done in the fixed assets section while the fixed assets working papers indicate the tests are done in the revenue and expense section.

The in-charge can use a list for future reference and control, sometimes referred to as a *point sheet*, or to-do notes, in order to do the following:

- Keep track of items to be completed.
- Identify items useful for tax returns.
- Identify items to be included in the management letter or other communications.
- Identify items to be considered next year.

The in-charge should clear all items on the point sheets and document their disposition and the supporting reasons, unless they are self-evident. (Generally, the staff responds to all items on the point sheets [review notes] and the in-charge reviews the responses and determines whether they have been sufficiently addressed.)

Be brief, but understandable, and write review comments that

- have substance;
- add to your knowledge of the client;
- train your staff auditors; and
- add to the quality of the working papers and report.

Check to ensure that the information presented is clear and complete – especially that

- tick marks are explained adequately;
- explanations are concise and understandable; and
- sources of information are indicated.

Ask yourself if any of the following have been overlooked:

- Is the scope adequate?
- Are the problems followed to their logical conclusion?
- Were any areas overlooked?

Finally, as the reviewer, you should be alert to extraneous working papers and remarks that do not constitute audit evidence and are inappropriate. Such material should not be left in the working papers.

# Completing the audit

It often falls to the in-charge accountant to make sure the working paper files are complete, indexed, and filed. AU-C section 230, *Audit Documentation*, requires that

- all audit working papers be placed in an audit file;
- the file be completed on a timely basis, within 60 days of the report release date; and
- the file indicates the report release date.

Between the report release date and the documentation completion date, the auditor is allowed to

- complete the documentation and assembly of audit evidence that the auditor has obtained, discussed, and agreed with relevant members of the audit team prior to the date of the auditor's report;
- perform routine file-assembling procedures such as deleting or discarding superseded documentation and sorting, collating, and cross-referencing final working papers;
- sign off on file completion checklists prior to completing and archiving the audit file; and
- add information received after the date of the auditor's report, for example, an original confirmation that was previously faxed.

# Review notes and point sheets

In reviewing working papers, the in-charge may need to record important aspects of the process as they occur. These may be comments or points concerned with *clerical matters*, such as a failure to properly head-up or initial working papers. Other comments may be *substantive* in nature and deal with the completion of the audit procedures, the adequacy of audit evidence, and the adequacy of the financial statements' presentation and disclosures.

The review comments, regardless of their nature or subject, will usually require some action. The review notes or point sheet, in its simplest form, contains notes on the various points on the left part of the page. The right hand column is then used for the resolution of the matter.

The individual to whom the comment was directed would indicate the action taken by explaining it in the designated column of the point sheet and appropriate working papers or memoranda where additional comments or explanations appear.

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## Clerical comments

Clerical comments usually require correcting the working papers, and the individual will indicate the action taken by writing "Done" or "Completed" *on the point sheet*. If not easily identifiable, also note where the work was done (for example, "Done, see working paper G-2 tick mark #").

A common issue is whether the reviewer who notes minor clerical issues, such as a missing balance sheet date or working paper title should write a review note or merely correct the problem directly in the working papers. On the one hand, it is generally simpler to fix the problem than to write a note, have the staff person fix it, and then check to see the problem has been resolved. On the other hand, part of reviewing working papers is educating the staff on proper working paper technique; fixing the problem without involving the staff person leaves him or her unaware of the need to improve. A reasonable compromise is that if the problem is isolated, it is more efficient for the reviewer to fix it. However, if it is more pervasive, the reviewer should call for the staff person to rectify it.

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## Substantive comments

Substantive comments usually require the individual to perform additional audit procedures, accumulate additional evidence, or perhaps explain items considered in reaching a decision on an accounting or reporting matter.

Note that this documentation of the actions taken on substantive comments should be provided on the working paper or in memoranda in the working paper sections to which the comments relate – not merely on the point sheets.

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## Reviewer comments

The reviewer may comment on particular working papers, or sections of them, by writing comments on the working papers to which they relate. However, if the comment is substantive, it should be clear that the addition was made by the reviewer, not the original preparer. This can be accomplished by initialing the comment.

# Documenting the review

When the reviewer has determined that all points and comments have been properly cleared, the point sheets are no longer a necessary part of the audit working papers.

The standards are silent on the disposition of completed review notes. Some firms retain them as a record of supervision. However, most discard them as unnecessary, reasoning that they add nothing of value as long as the working papers themselves are complete and they might be read out of context if the engagement is later the subject of litigation.

Exhibit 8-1 illustrates a common form of review notes.



**Exhibit 8-1 Illustration of review notes page**

W/P	Comment	Response
50-1	Sign and date w/p	Done
	Agree total to T/B	Done
50-3	What was the source of data in column 3?	Cash receipts journal; added to w/p
50-5	Because the misstatement you found in the sample is related to the price, the projection of the error to the population s/b based on value of the sample, not the number of items selected.	Recalculated on w/p Projected error increased to \$5,900.

AU-C section 230 requires that the working papers indicate not only who prepared the working papers and date of preparation, but also who reviewed them and the date of the review. The standards do not require that the reviewer's name or initials appear on each working paper reviewed, although this is a common approach. Indication of the review, alternatively, can be done, for example, through a memo or an indication on the audit program.



# Nuts and bolts of reviewing

We will complete this section of the course by briefly describing the nuts and bolts of reviewing.

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## Knowing the client

Where you start depends on your knowledge of the client. You must familiarize yourself with the engagement. You can accomplish this by

- reading the correspondence file before you leave the office;
  - scanning prior year financial statements and the pencil draft of current year financials, if there is one;
  - reading descriptions of internal control and the prior-year management letters. Also, reading the draft of the current-year internal control and management letters prepared at interim before beginning year-end work;
  - scanning the trial balance and all adjusting journal entries; and
  - looking at significant ratios and comparing them with the prior year.
- 

## Proceeding with the review

Once you are familiar with the client, you should

review the *permanent file* and

- determine if it complies with your firm's requirements;
- thoroughly review system documentation;
- understand the ramifications of new items, such as new debt or lease agreements; and
- prepare notes regarding the possible need for scope adjustments; and

review the *working papers* by asking the following questions:

- What does this working paper tell me?
  - Was the scope of the work correct – not too wide or narrow?
  - Were the working papers prepared in accordance with firm standards?
  - Was the audit program completed? Are all nonapplicable and passed items explained?
  - Is there anything unexpected in the working papers? Have such items been handled correctly? Is the partner aware of the situation?
  - Are working papers adequately cross-referenced and in agreement with the working trial balance or lead schedules?
  - Is the documentation professional and neat?
  - Have all unnecessary notes and extraneous comments been removed from the working papers?
  - Was enough time spent on the job? Do the working papers support the time spent? Are variations from the budget explained? Do they make sense?
  - Does the accounting conform to GAAP, applied on a basis consistent with the prior year? Are there any special disclosures or problems?
  - Is the subsequent events work adequate?
-

Here are four pointers on review notes:

- They should be written to correct deficient work.
- They should be positive in tone.
- They should aid in staff training.
- Answers and clarifications should not be recorded solely on the review notes; they should be reflected in the working papers.

Next, the financial statements should be reviewed to ensure that they are in accordance with GAAP, the format complies with firm standards, and that all numbers are referenced to working papers. Also, footnote disclosure should be adequate and well written. Finally, the planning file for next year should be examined and modified as necessary.

Appendix 8A provides a checklist that can be used in performing the in-charge review.

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## Wrapping up

To wrap up the review, ensure that the following questions have been answered:

- Have all review notes been cleared?
- Has the detail review checklist been completed?
- Have open "to do's" been listed separately?
- Are files ready for tax review or the file room?
- Have all sections of the audit program been dated and signed?
- Have problem areas on the engagement been discussed with the engagement partner?
- Have all the working papers been placed in an audit file within 60 days of the report release date?

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## Knowledge check

4. Where would a working paper review start?
  - a. Understanding the client's business.
  - b. Looking at the prior year reviewer's notes for the relevant working paper section.
  - c. Ensuring that the detailed review checklist has been completed.
  - d. Working backwards from the final financial statements.

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## Summary

This chapter discussed the following:

- What to look for when reviewing working papers.
- Guidelines for working paper review.
- Communicating the review comments.

## Appendix A

# REVIEW CHECKLIST

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This appendix is included for supplementary purposes only and is not required for CPE credit.



Client\_\_\_\_\_ Balance Sheet Date\_\_\_\_\_

Working paper section\_\_\_\_\_

Working papers reviewed by\_\_\_\_\_ Date\_\_\_\_\_

This checklist can be used by the in-charge accountant in performing the detailed review of working papers. It deals with general working paper technique and requirements specific to the types of working papers generally covered by the in-charge's detailed review.

The checklist can be used as a memory jogger or to document the working paper review. To complete the checklist, the second column can be used to record the in-charge's conclusions about each item for example using a check mark or "yes" to indicate compliance, "N/A" to indicate inapplicability in the circumstances, or a comment to indicate the need for follow-up.

Item	Response
<b>General</b>	
1. Do all working papers have a heading that shows the name of the client, identification of the working paper, and balance-sheet date?	
2. Does each working paper identify who did the work and the date? (Working papers prepared by the client should also indicate that.)	
3. Is each working paper numbered and cross-referenced as necessary?	
4. Is the source of the information on the working paper indicated or otherwise clear?	
5. Is the objective of the test or purpose of the working paper clear?	
6. Are all tick marks explained?	
7. Are the results of the tests and any conclusions clear?	
8. Are explicit or implicit conclusions supported by the test results?	
9. Are test results consistent with tests in related sections?	
10. Are any open items clearly identified for later follow-up?	
11. Are schedules arithmetically correct?	
12. Do inquiry procedures indicate to whom the inquiry was addressed, the person's job title, the date of the inquiry, and response (along with any necessary follow-up done)?	
13. Do detail schedules agree to the lead schedule?	
14. Has irrelevant or gratuitous material been removed?	
15. Is the language used appropriate?	

Item	Response
<b>Substantive procedures</b>	
1. Have all steps in the audit program been done?	
2. If the procedures applied deviated from the audit plan has the partner approved the substitute procedures and has the audit program been revised?	
3. Is the evidence obtained appropriate, sufficient to achieve the audit objective, and clearly described?	
4. If the test applied relies on client data, has the completeness and accuracy of that data been considered?	
5. If the procedure is a test of details, are individual items tested identified or identifiable?	
6. If the procedure involves sampling, are the items expected to be representative of the population?	
7. If the procedure involves confirmation, has the correspondence directly gone to and come from the responding party? (If the response was electronic, has the authenticity of who actually sent it been considered?)	
8. If the procedure is an analytical procedure, and <ul style="list-style-type: none"> <li>a. Is the expectation clear?</li> <li>b. Have explanations for deviations from the expectation been corroborated?</li> <li>c. Are any additional tests done in response and their results documented?</li> </ul>	
9. If misstatements have been identified: <ul style="list-style-type: none"> <li>a. Have they been dealt with appropriately? (Misstatements should not be presumed to be isolated circumstances.)</li> <li>b. If they resulted from a sampling application, have they been projected to the population from which the sample was drawn?</li> <li>c. Have they been posted to the summary of misstatements identified?</li> <li>d. Have they been identified as known or likely?</li> <li>e. Have other ramifications (for example, fraud, going-concern implications, or weaknesses in internal control) been considered?</li> </ul>	
10. Has the balance been agreed to the trial balance (or lead schedule that has been agreed to the trial balance)?	
11. Has the prior-year balance been agreed to the prior-year working papers?	

Item	Response
<b>Internal control</b>	
1. Have all steps in the audit program been completed?	
2. If the procedures applied deviated from the audit plan, has the partner approved the substitute procedures and has the audit program been revised?	
3. Does the description of internal control include the procedures both automated and manual systems, by which transactions are initiated, authorized, recorded, processed, and reported in the financial statements, including the accounting records and specific accounts involved?	
4. Have the walkthroughs been done to determine that the controls documented have been implemented?	
5. If tests of controls have been performed <ul style="list-style-type: none"> <li>a. Are the items tested identified or identifiable?</li> <li>b. Have the cause and effect of deviations been considered? (Deviations should not be presumed to be isolated instances.)</li> <li>c. Does the deviation rate in the tests support the planned assessment of control risk?</li> <li>d. Did the test accomplish its objectives?</li> <li>e. If the control risk assessment relies on the results of tests done in a prior year, do the working papers document the conclusions reached with respect to the use of the prior-year evidence?</li> </ul>	
6. Has each control weakness identified been classified as either a deficiency, significant deficiency, or material weakness?	
7. If insignificant deficiencies have been reported to the client orally, is that communication documented?	







## Chapter 9

# Typical Working Paper Shortcomings

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### Learning objectives

After completing this chapter, you should be able to do the following:

- Identify typical working paper shortcomings.
  - Apply this knowledge to the review of common types of working papers.
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### Introduction

This chapter is intended to familiarize you with the common deficiencies of working papers so you will be able to recognize and remedy them when you encounter them in practice. It starts with a listing of the most common deficiencies of working papers.

# Types of typical shortcomings of working papers

While you want to correct all shortcomings in audit working papers, some are more significant than others. It is more important that problems of higher significance get corrected than those that have less of an impact on the quality of the audit. In general, shortcomings can be stratified in descending order of importance as follows:

- Lack of evidence or failure to carry out a procedure
- Lack of clarity about what the staff member did and found
- Inefficiencies
- Clerical issues, such as headings

Many shortcomings represent inadvertent omissions or oversights. Others represent a lack of understanding of the audit objective or significance of findings:

- The client's accounting procedures are not described adequately. For example, computer applications are not described.
- The scope requirements (such as the required percent or the number and amount of accounts receivable to be confirmed, the required percent or number of documents to be inspected, and so on) are poorly documented.
- Findings or conclusions are not satisfactorily stated or evident.
- Footings, calculations, and rounding are inaccurate or unchecked (particularly on client-prepared schedules).
- Technical memos on significant auditing or accounting problems encountered have not been prepared or are inadequate.
- The source of data (when not obvious) is not indicated.
- Preparers' or reviewers' signatures or initials are missing.
- Dates, names, amounts, procedures, or other pertinent information are missing.
- The date the work was performed and the working paper was prepared is not shown.
- Tick marks are unexplained.
- Working paper headings are incomplete.
- Working papers prepared by the client do not bear the "PBC" notation or do not also indicate the auditor who tested the data.
- Cross-references are incorrect, incomplete, or missing.
- Working papers are not properly indexed.
- Exceptions, questions, to-dos, or pending matters were not properly cleared or carried forward to a final pending-matters list.
- The disposition of exceptions, of to-do's, and of other matters is not adequately documented.
- Adequate data, including correct names, amounts, dates, and so on, for the preparation or support of reports, footnotes, and letters has not been gathered.
- Some tasks were performed mechanically and evidence the resulting lack of understanding of the overall purpose of the procedures.
- The format of the prior year's working paper was followed, even when it was not the most effective approach.
- Previous "for next time" memos and the prior year's working papers were inadequately reviewed or followed, resulting in unnecessary duplicate work.
- Trails in summarizing figures, particularly those used in financial statement and footnote preparation, are inadequate or nonexistent.

- References to conversations have no evidential support.
- Important information, such as serial numbers, the spelling of names, dates, property or other asset descriptions, amounts, debt terms, and so on, needed for confirmation, inspection, or other procedures is not accurate or legible.
- Confirmations were for the wrong amounts or were sent to the wrong parties or the wrong addresses because they were not double-checked before mailing.
- The permanent file was not carefully updated.
- Beginning balances were not traced back to the prior year's ending balance.
- Adjusting and reclassification entries, including last-minute ones, were not posted to the trial balance or applicable working papers.
- Useless information has been transcribed on the working papers.
- Exceptions were not properly brought to the client's attention or acknowledgments were not obtained or documented.
- Important calculations on the working papers were not rechecked.
- Adjusting entries were not checked for correct posting by totaling and balancing the adjusting entry working paper and by proving the net change in the net income or loss.
- Reclassification entries were not checked for correct posting by totaling and balancing the related working papers.
- There is no documentation to show that working papers prepared by assistants were promptly reviewed by the in-charge accountant.
- Some required questionnaires were not completed.
- Effective control over supporting records and documents was lost or nonexistent.
- Some of the data necessary for the preparation of the income tax return(s) were not obtained.
- Applicable standard working papers forms prescribed by the firm were not used.
- The budget and time summaries were not properly completed.
- Observations and other items that are pertinent to the preparation of the report, communications about internal control, and the management letter were
  - not properly recorded or fully documented and
  - scattered throughout the working papers rather than being consolidated on a master listing with cross-references to the supporting working papers and to the report and letter drafts.
- The most important exceptions and comments, which the in-charge accountant must know about when preparing the draft report and letters, were not adequately spotlighted so that he or she could discuss them with appropriate client personnel and the partner or manager and issue additional and timely instructions to the staff.

---

## Knowledge check

For questions 1–3, select the choice that is a typical working paper shortcoming.

1.
  - a. The auditor did not document the checking of mathematical accuracy of schedules prepared by the auditor.
  - b. The auditor did not document the checking of mathematical accuracy of schedules prepared by the client.
  - c. The client did not document the checking of mathematical accuracy of schedules it prepared for the auditor.
  - d. The auditor did not document the checking of mathematical accuracy of all columns on a schedule when only some columns are relevant to the work done.

2.

- a. The heading of the working papers uses an abbreviated version of the client's corporate name.
- b. The date the audit work was performed is not shown.
- c. The name of the reviewer is not shown on each working paper.
- d. The working paper does not indicate the objective of the procedure.

3.

- a. Working papers prepared by the client do not indicate that it was prepared by the client.
- b. Working papers prepared by the client do not indicate the date the client prepared it.
- c. Working papers prepared by the client are copied over to the audit firm's standard form.
- d. Working papers are prepared manually rather than on a computer.

# Examples of working paper shortcomings

Exhibits 9-1 through 9-9 illustrate weaknesses in documenting common types of audit procedures. Review each exhibit and note the weaknesses before reading the critique that follows each one.

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## Tests of details

Working papers documenting tests of details normally show the following (in addition to basic elements of working paper preparation, such as identification of the client, balance sheet date, preparer, date, and index number):

- Nature, timing, and extent of the test
- Account balance
- Date of balance tested (particularly if a date other than the balance sheet date)
- Items tested
- Exceptions and their disposition

In addition, the working papers should indicate the objective of the test and how it links to the risks assessed at the assertion level, although this information might be documented separately in a memo or the audit program.

It is generally impractical to expect staff auditors to copy and include all audit evidence examined. However, copies or abstracts of client records should be included if they would be necessary for an experienced auditor with no previous connection with the audit to understand the work done and conclusions reached.



## Exhibit 9-1

### Conrad Manufacturing Co., Inc Commercial Bank--Regular Account

W/P No. **B-2**

Prepared by: Date:

Reviewed by: Date:

	Balance 5/31/X1	Receipts	Disbursements	Balance 6/30/X1
Per bank statement	1,433,663.25	1,350,640.25	1,420,610.10	1,363,693.40
Deposits in transit				
5/30/X1				
6/15/X1		25,315.45 ☞		25,315.45
Outstanding checks				
5/30/X1 <b>B-3</b>	(286,917.21)		(286,917.21)	
6/15/X1 <b>B-4</b>			245,315.42	(245,315.42)
Per books	1,146,746.04	1,375,955.70 ⚭	1,379,008.31 ⌘	1,143,693.43
	<b>F</b>	<b>F</b>	<b>F</b>	<b>F</b>

177.77  
27.01 +  
 204.78  
2 /  
 102.39

**F**- Footed by auditor.

☞ -Credited by bank on 7/1/X1

⚭ - Per cash receipts book, which was footed by auditor.

No exceptions noted.

⌘ - Per cash disbursements book, which was footed by auditor. No exceptions noted.

### Your observations:

### Weaknesses noted:

1. The accountant neglected to sign the working paper.
2. The accountant neglected to date the working paper.
3. The heading is incomplete; it should include the name of the schedule.
4. The heading should include the balance sheet date.
5. The balance per books on 5/31/X1 and 6/30/X1 should be traced to the general ledger.
6. There is no need to foot schedules prepared by an auditor. They are presumed to be arithmetically correct. Only schedules prepared by client personnel should be footed and cross-footed.
7. Working papers should not be used as scratch paper (that is, the apparently irrelevant calculation should not be made on the working paper; if it is relevant, it should be explained).



## Exhibit 9-2

Sherfy Construction Co.  
Analysis of Sundry Advertising  
Expense A/C 705  
12/31/X1

W/P No. **X-3**

Prepared by: **BG** Date: **1/2/X2**

Reviewed by: Date:

All charges > \$1,000

1/X1	2,350
2/X1	1,083
3/X1	2,342
4/X1	521
5/X1	1,530
6/X1	4,000
Other	<u>32,521</u>
Total 12/31/X1	<u>44,347</u> <b>G/L</b>
	<b>A-8</b> (Changed T/B)

**G/L** Traced to general ledger.

Your observations:

### Weaknesses noted:

1. This poorly constructed working paper is not really an analysis; it tells the reader nothing about the composition of the account.
2. The total of each month's posting is virtually meaningless, except as a means of ensuring the arithmetic accuracy of the schedule.
3. The source of the data is not indicated. If the source was the general ledger the tick mark stating the balance was "traced to the general ledger" is meaningless.
4. The monthly detail covers only six months. It appears that the auditor did not have the entire source at his disposal.
5. It is unnecessary to agree a working paper to both the trial balance and the general ledger as the entire trial balance should be agreed to the general ledger separately. Further, there is no indication of what "*changed T/B*" means.
6. No audit testing is indicated, nor is there any rationale for the lack of testing.



## Exhibit 9-3

Steele Trailer & Coach Co.  
Accrued Product Warranty  
12/31/X1

W/P No. **O-2**

Prepared by: **BG** Date: **1/26/X1**

Reviewed by: Date:

			Expense
Beginning balance	75,000.00		
Accrued	36,000.00	✓	36,000.00
Paid	43,500.00	✓	
	67,500.00		
Add back at year-end	<u>(17,500.00)</u>	✓	
Balance 12/31/X1	<u>50,000.00</u>	❖	

Note to tax dept:  
The deduction is not equal to the accruals

- ✓ Agreed to general ledger.
- ❖ Mr Owens, Sales Dept., says that the amount of claims is going down so the reserve should be down also.

### Your observations:

### Weaknesses noted:

1. The beginning balance has not been agreed to the prior-year working papers.
2. The accountant failed to agree the total warranty expense to the general ledger.
3. The transaction titled "add back to year-end" is not clear; also, the number is negative, which further reflect on the description's shortcomings.
4. The note to the tax department is not effective; it tells the reader nothing about the basis for the deduction or the deduction itself. The note is therefore useless for the purposes of preparing the tax return and the audit tax provision. It also presumes that the tax department will review each working paper in detail to find this note. It is better to summarize issues for the tax department separately.
5. The accountant failed to describe any audit steps performed other than merely agreeing the activity to internal records and an ineffective analytical procedure (there was no analysis or corroboration of the client's explanation).





## Exhibit 9-4

Weaver Co.  
Sales and Retirements  
Y/E 12/31/X5

W/P No. **G-5**  
Prepared by: **JHR** Date: **2/18/X6**  
Reviewed by: Date:

Date Acquired	Disp Ord #.	Description	Cost	Accum Depr	Proceeds	Gain (Loss)
Machinery and Equip.						
5/5/W6	11	Sale of grinding mach	⊕ 17,875.00	16,816.00	5,000.00	◆ 3,941.00
8/13/X1	13	Sale of perforator	⊕ 43,575.00	41,300.00	15,000.00	◆ 12,725.00
6/19/X4	17	Sale of slicer	⊕ 17,882.90	17,120.00	5,000.00	◆ 4,237.10
2/16/W9	18	Sale of press brake	⊕ 3,500.00	3,350.00	382.55	232.55
various	19-23	Retire misc. machinery	2,214.00	2,200.00		(14.00)
			85,046.90	80,786.00	25,382.55	21,121.65
			<b>G-2</b>	<b>G-3</b>		<b>A-3</b>
Autos and Trucks						
JO3794		Trade in 3 pick up trucks	6,373.00	4,478.00	2,100.00	205.00
			<b>G-2</b>	<b>G-3</b>		<b>#</b>

Work performed:

- ⊕ Authorization for sales referenced to corporate minutes. **K-3**
- ◆ Traced proceeds amount to sale documents and the the general journal entry recording the sale.
- # Gain not recognized as company follows income tax method of recording trade-ins. Basis of new trucks purchased was reduced by this amount.

Disposal orders on retirements were examined for overall propriety and approval.

### Your observations:

### Weaknesses noted:

1. There is no indication that the cost and accumulated depreciation used here agreed to the detailed records. Although that might be shown on another working paper, this working paper seems to be the most logical and efficient place to do that.
2. Gain on auto trade-in "not recognized as company follows income tax method of recording trade-ins." Although an adjusting entry would probably be waived, because of the relative immateriality of these exceptions, their disposition should be made explicit on the working paper.
3. Disposal orders 12, 14, 15, and 16, are not accounted for.



## Exhibit 9-5

XYZ Corp.  
Professional Fees  
Y/E 12/31/X1

W/P No.  
Prepared by: **JF**      Date: **2/9/X2**  
Reviewed by:              Date:

<u>Date</u>	<u>Description</u>	<u>Amount</u>
15/X1	A.B. Hoffman	20,000 ✓
3/12/X1	A.B.C CPAs	10,500 ✓
7/1/X1	Simons & Simons	4,700 ✓
9/1/X1	A.B. Hoffman	<u>6,500</u> ✓
		<u>41,700</u> T/B

- ✓ Examined invoice for services rendered.  
T/B Traced to general ledger trial balance.

Your observations:

### Weaknesses noted:

The working paper demonstrates a lack of understanding of the audit objectives.

While it is important to examine recorded expenses as they may indicate further unrecorded items (for example, legal fees entail the possibility of litigation, which in turn entails the possibility of liability resulting from unfavorable judgments), one of the primary objectives of a review of professional fees expense is to determine the possible existence of unrecorded liabilities. To test for unrecorded liabilities, the auditor must begin his or her tests at the source (as opposed to the general ledger).

To further test legal expenses, generally, in the attorney confirmation requests auditors also ask the attorneys to indicate the amount of outstanding or unbilled fees as of year-end.



## Exhibit 9-6

Prepared by *CBC*

Date *1/21/X2*

### Valley Corporation test of inventory pricing 12/31/X1

Item No.	Quantity	Price	Total value
123	200	21.00 ✓	420.00
456	100	8.50 ✓	85.00
789	50	103.20 ✓	5,160.00
012	627	51.01 ✓	31,983.27
345	500	25.00 ✓	12,500.00
678	39	17.00 ✓	678.45
901	1107	28.90 *	31,992.30
234	29	15.00 ✓	451.20
567	451	73.31 ✓	33,062.81
890	30	196.12 ✓	5,883.60

✓ Agreed to price allocation voucher; appears reasonable

\* Price per voucher was 26.90; difference immaterial.

#### Your observations:

#### Weaknesses noted:

1. There is no indication of the source of the data or whether it agrees to the year-end inventory list.
2. It is apparent that the extensions on items 678 and 234 must be wrong, as they should obviously end in even dollars.
3. The conclusion that the difference in price is premature. As this is a sampling application, the difference in value needs to be projected to the population.
4. The most glaring defect of the working paper is that it does not appear the test achieves anything meaningful. The staff person has apparently only agreed the price to internal company documents, not external evidence such as invoices.

# Analytical procedures

Analytical procedures are evaluations of financial information made by a study of plausible relationships between both financial and nonfinancial data. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to continue in the absence of known conditions to the contrary.

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## Analytical procedures performed as risk assessment planning procedures

*Preliminary analytical procedures* are intended to enhance the auditor's understanding of the client's business and the significant transactions and events that have occurred since the prior audit. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud. Thus, the auditor performing preliminary analytical procedures looks for such things as unusual transactions, events, amounts, ratios, and trends that indicate matters that have audit implications.

The auditor develops expectations about plausible relationships and when observed relationships are unusual or unexpected, the auditor considers them in identifying the risk of material misstatement.

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## Analytical procedures performed as substantive tests

Analytical procedures used as *substantive tests* are applied to obtain evidence about an account balance or class of transactions. Tests of details substantiate individual items. From these tests, we gain assurance about the validity of groups of similar transactions or the details underlying account balances. In contrast, analytical procedures do not focus on the details that make up the balance but deal with recognizing overall relationships between accounts or amounts. This includes balance sheet and operating accounts, and their relation to each other and to pertinent economic factors. The procedures are subjective, depending heavily on our independent judgment as accountants, and are valuable primarily in evaluating the reasonableness of balances.

Analytical procedures include the following:

- Comparing the financial information with information for any comparable prior periods.
- Comparing the financial information with anticipated results; for example, budgets and forecasts.
- Studying the relationships of elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience.
- Comparing the financial information with similar information on the industry in which the entity operates.
- Studying relationships of the financial information with relevant nonfinancial information.

These comparisons can be applied to most accounts in the financial statements to ascertain whether a ratio or trend exists or should exist.

Analytical procedures are used in the *final review* of the engagement to assist in assessing the conclusions reached during the audit and in evaluating the overall financial statement presentation.

Preliminary and final analytical procedures concern themselves with overall issues of planning and strategy and conclusions or judgments, respectively. So while the in-charge might be involved in performing these procedures or even reviewing them, they are generally reviewed closely by the manager or partner making the executive decisions. The in-charge review is generally primarily concerned with reviewing analytical procedures used as substantive tests. They might be documented on a worksheet, in narrative form, or as part of the audit program.

Analytical procedures working papers generally document

- the balance tested;
- date of the balance tested (particularly if other than the balance sheet date);
- the auditor's expectation, which is either explicit or otherwise evident—when the test is a substantive procedure for an account, factors used in developing the expectation also need to be documented unless otherwise evident; failure to document expectations is a common peer review finding;
- the comparison made;
- explanation for any variations from the expectation;
- corroborating evidence for the explanation; and
- any additional audit procedures applied in response and their results.

Review exhibits 9-7 and 9-8 and record your observations regarding any deficiencies, then compare your observations to the weaknesses noted that follow.



### Exhibit 9-7

*Working paper xx*

#### Spear Manufacturing Co. analysis of comparative income statements December 31, 20X1

	20X1	20X0	Change
Sales	\$ 1,000,000	\$ 1,000,000	—
Cost of sales	625,000	750,000	–16.7% <sup>1</sup>
Gross profit	375,000	250,000	+50.0%
Percent of sales	37.5%	25.0%	
Operating expenses	262,500	100,000	+162.5% <sup>2</sup>
Percent of sales	26.3%	10.0%	
Profit from operations	112,500	150,000	–25.0%
Income tax	32,500	49,750	–50.5%
Net income	<u>\$ 80,000</u>	<u>\$ 100,250</u>	–10.2%

<sup>1</sup> Consistent with change in inventory values, page yy.

<sup>2</sup> Per Samuel Spear: salaries were higher in 20X1 due to a new union contract.



## Exhibit 9-7 (continued)

*Working paper yy*

### Spear Manufacturing Co. analysis of comparative inventories December 31, 20X1

Inventories at year-end and the related turnover rates (which you have calculated) are as follows:

	20X1	20X0	Change
Inventories:			
Finished goods	\$ 125,000	\$ 150,000	-16.7%
Work in process	87,500	100,000	-12.0%
Raw materials	50,000	50,000	—
Total	\$ 262,500	\$ 300,000	-12.5% <sup>1</sup>
Turnover rates:			
Finished goods	4.5	5.0	-10.0%
Work in process	6.3	7.5	-16.0%
Raw materials	5.0	5.0	—

<sup>1</sup> Decrease in inventory of 12.5 percent is consistent with the decrease in cost of sales, 16.7 percent – see page xx.

#### Your observations:

#### Weaknesses noted:

1. Neither working paper indicates the source of the data. In neither case has the prior-year information been agreed to the prior-year working papers.
2. The inventory working paper (yy) does not show the calculation for turnover rates. Demonstrating how the amounts were derived shows the reviewer that the technique is correct and does not need to be recalculated.
3. Although there is no indication of the expectation it seems evident the auditor expects the current year to approximate the prior year. There is, however, no explanation of how the auditor decided which items needed follow-up.
4. There is no corroboration of the explanation for the change in operating expenses, nor any indication of why it only affects that line item.
5. It is possible that the decrease in cost of sales and the increase in operating expenses are related. The comparison of the change in inventory to the change in cost of sales is a useful check, but does not provide evidence regarding the explanation for the variation. Note, for example, that material costs seem unchanged. It could be that costs that should be charged to manufacturing have, instead, been shifted to operating costs.



## Exhibit 9-8

Prepared by *ABC*  
1/31/X2

**Am & A Co.**  
**analysis of results by product line**  
**12/31/X1**

	20X0		20X1	
Line A sales	600,000	100%	650,000 <i>R</i>	100%
Line A cost of sales	354,000	59%	455,000 <i>A</i>	70%
Line A gross profit	246,000	41%	195,000 <i>A</i>	30%
Line B sales	600,000	100%	400,000 <i>B</i>	100%
Line B cost of sales	480,000	80%	320,000 <i>C</i>	80%
Line B gross profit	120,000	20%	80,000 <i>R</i>	20%
Line C sales	550,000	100%	1,000,000 <i>D</i>	100%
Line C cost of sales	391,000	71%	722,000 <i>E</i>	72%
Line C gross profit	159,000	29%	278,000 <i>R</i>	28%

- R* Reasonable when compared to previous year.  
*A* Increase in cost of sales due to book to physical adjustment in 12/X1.  
*B* Sales increase due to refocus on sales of reconditioned versus new goods.  
*C* Due to lower sales.  
*D* Sales increase due to increase in sales at River City location.  
*E* Due to higher sales.

### Your observations:

### Weaknesses noted:

1. It is unclear why the book to physical adjustment would affect cost of sales in line A (tick mark A). The adjustment would merely affect the month in which the difference was booked; it does not explain why that would affect year-to-year comparisons.
2. Tick mark B notes a change in sales mix, but there is no change in gross profit percentage. Would consistent gross profit be expected with a change in sales mix?
3. The explanations for tick marks C, D, and E provide no insight or explanation of why these variances occurred.
4. If everything else on the page changes, is it reasonable to expect line A sales and line C gross profit percentage to be the same as the prior year?

# Summary of misstatements

AU-C section 450, *Evaluation of Misstatements Identified During the Audit*,<sup>1</sup> requires that working papers summarizing misstatements identified in the audit indicate

- all misstatements accumulated during the audit and whether they were corrected by management and
- the auditor's conclusion about whether the misstatements that are not corrected are material and the basis for that conclusion.

In addition, the working papers should indicate the threshold for clearly trivial misstatements, that is, amounts so clearly small that they need not be aggregated.

AU-C section 450 suggests, but does not require, that misstatements be distinguished as either factual, judgmental (that is, relating to estimates), or projected (that is, the result of extrapolating sample results to the population from which it was drawn).

In exhibit 9-9, assume the net income before any adjustment for any errors is \$30,000.

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## Knowledge check

4. For analytical procedures auditing standards require documentation of
  - a. The basis for the auditor's expectation.
  - b. Explanations for variances from the auditor's expectation.
  - c. The reason the tests applied are different from those done in the prior year.
  - d. The prior year's balance.
5. The summary of proposed adjustments needs to indicate
  - a. All adjustments identified by the auditor, except clearly trivial ones.
  - b. All adjustments identified by the auditor.
  - c. Only those adjustments identified by the auditor that were not corrected.
  - d. Only those adjustments posted by the client.

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<sup>1</sup> All AU-C sections can be found in AICPA *Professional Standards*.





## Exhibit 9-9

ROCKY HOSPITAL CORPORATION									
Summary of Errors - 12/31/X7									
Amount over/(under) stated									
Reference	Description	Cash	Accounts Receivable	Inventory	Other Current Assets	Other Assets	Current Liabilities	Other Liabilities	Revenue Expense
1-5	Unrecorded debit memos	200							(200) *
2-7	Unprocessed credit memos		3,000 *						(3,000) *
2-8	Allowance for Doubtful Accounts		3,300 *						(3,300) *
4-2	Unrecorded interest on employee note		(500)						(500)
9-3	Unaccrued property taxes 11/1/x7 to 12/31/x7						(2,000)		(2,000)
5-8	Physical test count			3,000 *					(3,000) *
5-9	Inventory cut-off			3,000 *					(3,000) *
5-10	Inventory pricing			9,000 *					(9,000) *
5-11	Inventory summarization			(1,000) *					1,000 *
9-1	Sales pricing		6,000 *						6,000 *
	Totals	200	11,800	14,000			(2,000)		5,500 (22,500)
	Client subsequently agreed to record	200	12,300	14,000					6,000 (20,500)
	Unadjusted Difference		(500)	—0—			(2,000)		(500) (2,000)
	Tax effect (37.5%)						750		750
	Totals		(500)				(1,250)		(500) (1,250)
	Reversal of Prior Year Passed items (net of taxes)								
	Understated property taxes 11/1/x6 to 12/31/x6								2,000
	Overstated Physical test count errors—20x6								3,000
									(500) 3,750
									500
	Discussion with Mr. Kare, Controller, on 2/28/x8, and he agreed to adjust the general ledger for items indicated with *								Effect on net income 4,250
Because of the immaterial effect on financial position and results of operations, no additional adjustments are considered necessary. Gave copy of above summary to Mr. Kare on 2/24/x8. Client to adjust remaining 20x7 errors in 20x8.									

### Your observations:

### Weaknesses noted:

1. The summary does not differentiate between factual, judgmental, and projected misstatements. The inventory misstatements might be any of them. This distinction is not required under generally accepted auditing standards, but may be helpful.
2. The summary shows only the misstatements' effect on net income, not on other elements such as current assets or gross profit.
3. Although the final "Effect on Net Income" amount is not affected, the current year's 50 percent income tax effect amount in both the "Revenue" and "Expense" columns is misstated by off-setting errors of \$250; that is, there should be a \$250 income tax understatement effect shown in the "Revenue" column and the income tax overstatement effect shown in the "Expense" column should be \$1,000 rather than the \$750 shown. This would result in current year after income tax effect "Totals" of (\$250) and (\$1,000) in the "Revenue" and "Expense" columns, respectively.

# Internal control

Working papers regarding internal control need to indicate the understanding of the five elements of internal control: control environment, risk assessment, control activities, information and communication, and monitoring. The most common deficiency in internal control documentation relates to failure to document the computer processing of transactions and amounts. The understanding of internal control cannot treat the computer as a black box but needs to indicate how data are processed.

Tests of the design, implementation, or operating effectiveness of controls, as applicable, should be documented much like substantive tests of details and should show the nature, timing, and extent of procedures applied, the source of information, and findings. When the tests involve inquiries they should indicate to whom the inquiries were made and the responses received.

Weaknesses in internal control may be identified in a variety of ways, including: by the staff person obtaining the understanding or testing internal control, by the in-charge reviewing the work, or as a result of misstatements identified during substantive procedures. When there are deficiencies in internal control, the auditor needs to determine whether they are significant deficiencies or material weaknesses, which must be communicated to those charged with governance. Paragraphs .A5–.A11 of AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*, provides application guidance when making this determination. As part of this determination, the following are two key items that require an analysis:

- The likelihood of potential misstatement: the auditor needs to determine if the likelihood is greater than remote.
- The magnitude of potential misstatement. The auditor needs to determine if the magnitude of potential misstatement is inconsequential, more than inconsequential, or material.

This can be a highly subjective exercise. In reviewing the staff's conclusions about the likelihood and magnitude of potential misstatements, the in-charge should be careful not to rely on the lack of actual misstatements resulting from the deficiency. The test is whether there is a likelihood of potential misstatement, not whether one actually occurred.

AU-C section 265 provides the following definitions:

- A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, detect and correct misstatements on a timely basis.
  - A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
  - A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.
- A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

- A *material weakness* exists when there is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Smaller companies often increase reliance on the control environment, as there is more direct oversight and reinforcement of the "tone at the top" by management. Management may rely more on its control environment and their own active participation in or monitoring of the controls over financial reporting. For example, active management oversight may partially compensate for inadequate segregation of duties. For example, management may provide a monitoring and oversight function that would preclude the occurrence of a material skimming of cash receipts, but might not be sufficient to preclude all skimming.

In those instances where management involvement may compensate for deficiencies in the design of other controls, consider that

- management's involvement in the operations of the business (for example, in managing relationships with significant customers, or obtaining financing) is not the same as its involvement in the controls over financial reporting; and
- management's active involvement in controls also increases the risk of management override of controls and the manipulation of financial reporting.

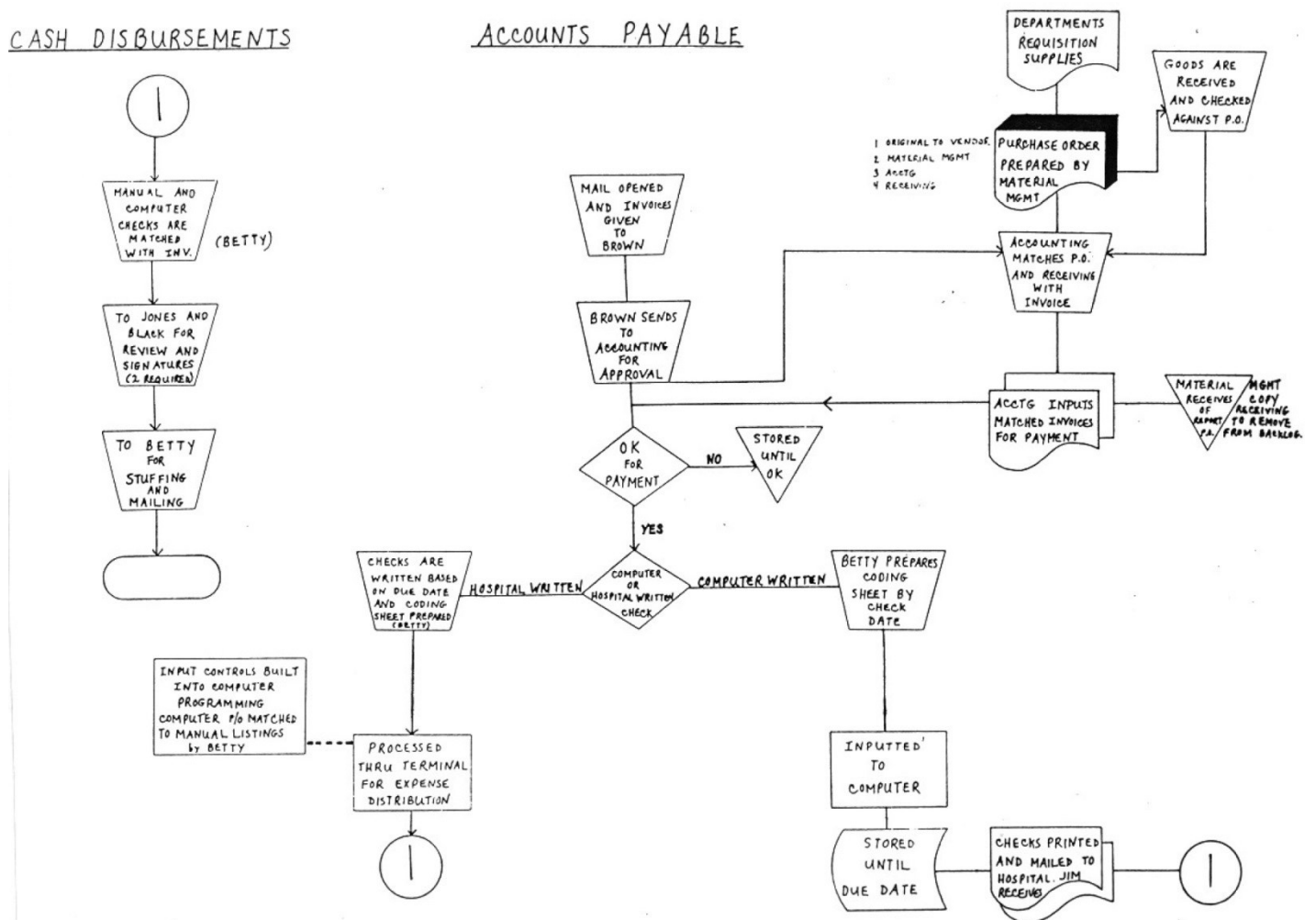
While there may be less direct reliance on control activities in smaller companies, there are certain foundational control activities that need to be in place in every company. Both smaller and larger companies will have similar control activities including reconciliations of key accounts, approvals of large transactions, and various input controls.

# I.M. Well Memorial Hospital case study

This case study involves many of the elements already discussed in this course.

Assume that you and your assistants are currently engaged in performing the annual audit of the I.M. Well Memorial Hospital for the year ended September 30, 20X9. Following are selected working papers that have been completed by your assistants and turned in to you.

Review these working papers and list any deficiencies that you may find, along with what you think might be done to adequately dispose of your review comments. (Do not be concerned about any working papers that are not reproduced in the case study.)



Your observations:

I. M. Well Memorial Hospital		<div><div>W/P No. <b>A-1</b></div><div><b>PBC</b></div><div>Prepared by: _____ Date: _____</div><div>Reviewed by: _____ Date: _____</div></div>			
General Bank Reconciliation					
9/30/X9					
a/c 110-00					
Balance per bank statement 9/30/X9	626,071.65	C		See A-1/3	
Less: O/S checks	(510,560.90)			From A-1/1, p.6	
Add: Deposit in transit	18,973.29	x			
Add: check #109419 in system 24,357.00; cleared bank 25,377.00	1,020.00	y			
Add: check #109588 in system 307.07; cleared bank 309.07	2.00	P			
Add: check #109616 in system 266.33; cleared bank 266.35	0.02	P			
Less: check #109617 in system 349.69; cleared bank 244.78	(104.91)	P			
Add: check #112043 in system 262.00; cleared bank 362.00	100.00	P			
	<u>135,501.15</u>				
	T/B 110-00				
C- Confirmed					
P- Passed					
x- Cleared 10/3/X9 per 10/11/X9 cutoff statement. Deposit dated 9/30/X9. Believe proper DIT at 9/30/X9					
y- Sighted check #109419 (handwritten check) for \$25,377. the amount was entered into the system at \$24,357, or \$1,020 less than the actual check. Therefore cash is overstated by \$1,020 at 9/30/X9. Pass adjustment as the amount is not material. Per discussion with Janet, a correcting entry was made in 10/X9.					
Per discussion with Janet, this error occurred due to a footing problem. There were several invoices totaled to prepare a check quickly. Later, when invoices were refooted and logged in as a cash disbursement, the amount entered into the system was \$1,020 less than the check because of a refooting error. Per Janet, the totals are supposed to be compared but this was missed and such items are only caught during the monthly bank recs.					

## Requests for Confirmations and Related Materials

.04

STANDARD FORM TO CONFIRM ACCOUNT  
BALANCE INFORMATION WITH FINANCIAL INSTITUTIONSI.M. Well Memorial Hospital  
CUSTOMER NAMEFinancial  
Institution's  
Name and  
AddressTenth National Bank  
1506 45th Street  
Sometown, USA 99099

We have provided to our accountants the following information as of the close of business on Sept. 30, 20X9 regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

ACCOUNT NAME	ACCOUNT NO.	INTEREST RATE	BALANCE*
See Attached			

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

ACCOUNT NO. / DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL

*James C. Black*  
(Customer's Authorized Signature)

Sept. 30, 20X9  
(Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

*Jana Banker*  
(Financial Institution Authorized Signature)

Oct. 4, 20X9  
(Date)

Vice President of Confirmations  
(Title)

EXCEPTIONS AND OR COMMENTS

Please return this form directly to our accountants:

Tick Mark & Co.  
Auditown, USA 99180

\* Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute. Additional forms available from: AICPA - Order Department, P.O. Box 1003, NY, NY 10108-1003

0 451 5951

[The next page is 7205.]

I.M. WELL MEMORIAL HOSPITAL Bank Cash Confirm A – 1/3

9/30/X9

11/2/X9 SRM

Amount	Account name	Account number	Subject to withdrawal by check	Interest-bearing Rate
\$626,071.65C To A - 1	General Checking	00-4205-8	Yes	5¼%
\$165,317.53C To A - 2	Payroll Checking	00-4206-6	Yes	—
\$9,721.06C To AD - 1	School of Nursing Loan Fund	19496-9	No	5¼%
\$11,449.08C To NTA - 1	Student Loan Fund	00-4209-7	No	—
\$74,110.44C TB 110-06 To IR - 1	Building Fund	0890481	No	5¼%
CLOSED TO SF - 1	Scholarship Fund	00-4240-6	—	—

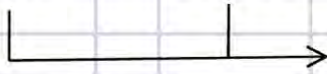
I. M. Well Memorial Hospital			
Payroll Account	W/P No. A-2	PBC	
9/30/X9	Prepared by: RAR	Date: 11/9/X9	
	Reviewed by:	Date:	
a/c 110-02			
Bank balance	165,317.53	C	See A-1/3
Less: o/s checks	(256,905.12)	b	c
Add: deposit in transit	100,000.00	a	
	8,412.41	F	d
	<b>T/B 110-02</b>		
F- Footed			
a- Deposit is from the general checking a/c. See A-1/1 p.3. Cleared cutoff on 10/3/X8			
b- Pay period ended 9/21/X8; checks were distributed on 9/29/X8. Therefore the majority of the payroll would be o/s on 9/30/X8. o/s check list was 34 pages long, believe unnecessary to include in w/ps. Sighted the o/s list--no items appeared large or unusual. In prior year 100% of payroll checks were o/s at y/e (\$309,559). Therefore a decrease in o/s checks at y/e compared to prior year is reasonable since checks cleared on 9/30/X8. Also, based on work performed and finding no o/s over our \$1,000 scope or any unusual items, believe it is not necessary to vouch any cancelled checks returned in cutoff statement.			
c- Last check number obtained at y/e was #248013. See w/p A-1/4. Per analysis of client's o/s check list, last check numbers agree. Believe cutoff proper at 9/30/X8.			
d- the payroll a/c earns interest. Therefore the balance consists of the original imprest \$1,000 balance plus all interest earned. Appears to be about \$4,000 of interest earned since 9/30/X7. Appears reasonable with \$3,500 earned in prior year.			



Your observations:

I. M. Well Memorial Hospital										
Patient Accounts Receivable Aging Carryforward										
9/30/X9							W/P No. <b>B-2/4</b> Prepared by: <b>AHG</b> Date: <b>11/6/X9</b> Reviewed by: <b>BLM</b> Date: <b>11/8/X9</b>			
a/c 111-01										
[Amounts rounded to nearest \$1]										
			Months since discharge				Updated	Reviewed		
	<u>Balance</u>	<u>In-house</u>	<u>0 - 4</u>	<u>5 - 7</u>	<u>8 - 19</u>	<u>Over 19</u>	<u>by</u>	<u>by</u>		
20X4	3,203,598	422,012	2,359,319	411,265	265,881	45,121				
	100%	13%	65%	13%	8%	1%				
20X5	4,603,422	325,263	2,573,702	354,243	299,046	51,168				
	100%	7%	78%	8%	6%	1%				
20X6	3,978,506	636,804	2,629,198	311,517	330,154	70,833				
	100%	16%	66%	8%	8%	2%				
20X7	4,252,690	663,643	2,960,093	285,651	204,224	139,079				
	100%	16%	69%	7%	5%	3%	* RCM	BLM		
20X8	5,373,224	1,023,343	3,657,634	397,389	239,053	55,805				
	100%	19%	68%	7%	5%	1%	* SRM	BLM		
20X9	5,407,288	989,118	3,720,262	285,137	335,759	77,012				
	100%	13%	68%	5%	6%	1%	* RAR			

I. M. Well Memorial Hospital				W/P No. <b>B-6</b>	
Allowance for Doubtful Accounts--Student Accounts				Prepared by: <b>RAR</b>	
9/30/X9				Date: <b>11/7/X9</b>	
				Reviewed by:	
a/c 112-45; a/c 691-75					
			<u>Expense a/c 691-</u>	<u>Allowance a/c</u>	
			<u>75</u>	<u>112-45</u>	
Balance @ 9/30/X8			0	(2,736.16)	
Write-offs:					
12/X7 D. Johnson	658.57	✓			
3/X8 R. Blacken	636.47			1,295.04	
Recoveries:					
10/X7: B. Jones	50.00				
11/X7: B. Jones	50.00				
12/X7: B. Jones	50.00				
V. Brownly	50.00				
1/X8: B. Jones	50.00				
V. Brownly	50.00				
2/X8: V. Brownly	75.00				
D. Johnson	40.00	✓			
V. Brownly	50.00				
3/X8: D. Johnson	618.57	✓			
B. Jones	50.00				
4/X8: B. Jones	50.00				
V. Brownly	25.00				
5/X8: B. Jones	50.00				
V. Brownly	25.00				
7/X8: B. Jones	100.00				
V. Brownly	25.00				
9/X8: B. Jones	50.00			(1,458.57)	
Balance @ 9/30/X9			0	(2,899.69) F	
			T/B 691-75	T/B 112-45	
Computation of allowance:					
Balance a/c 112-41				78,837.45	Agreed to w/p B-3
x 5.25%				5.25%	
Computed allowance				4,138.97	
Account balance				2,899.69	
Difference				1,239.28	Passed adjustment; not material
F- Footed					

I. M. Well Memorial Hospital					W/P No. <b>B-7</b>		<b>PBC</b>	
Farm Contracts Receivable a/c 112-60					Prepared by: <b>RAR</b>		Date: <b>11/9/X9</b>	
Interes Income on Farm Contracts a/c 571-01					Reviewed by:		Date:	
9/30/X9								
	Roger Landman		Interest income		John Farmer		Interest Income	
	Balance		@7.5%		Balance		@ 7.5%	
9/30/X8 Balance	17,500.00				18,000.00			
4/X9 payments	(2,500.00) *		1,312.50 R		(3,000.00) x		1,350.00 R	
Balance @ 9/30/X9	<u>15,000.00</u>		<u>1,312.50</u>		15,000.00		1,350.00	
Landman					<u>15,000.00</u>		<u>1,312.50</u>	
Total a/c					<u>30,000.00</u> F		<u>2,662.50</u> F	
					T/B 112-60		TB 571-01	
<b>F</b> Footed								
* Repayment consistent with prior years. Agrees with schedule on B-7/1								
x Double payment was made in this fiscal year, per Jim Barnes. See B-7/2								
R Recomputed. Agrees with schedules on w/p B-7/1 or B-7/2								

Your observations:



I. M. Well Memorial Hospital  
Accounts Payable--Unprocessed Invoices  
9/30/X9

W/P No. **BB-2**  
Prepared by: **SRM**  
Reviewed by:

**PBC**  
Date: **11/15/X9**  
Date:

a/c 210-05

Unpaid Invoices Held @ Y/E by Accounting Department*							
Vendor	P.O. No.	Invoice No.	Invoice Date	Amount	Account No.		
	51421	419748	9/29/X9	46.61	740-31	✓	Page Subtotal
[See note]		25027901	9/30/X9	(682.92)	731-30	✓	1 37,505.27
	51101	70490	9/30/XX9	66.00	655-38	✓	2 18,129.42
	51301	62303	9/26/X9	20.86	655-38	✓	3 12,751.44
			9/30/X9	410.40	753-60	✓	4 4,157.45
		273LSM019	9/30/X9	15.00	953-75	✓	5 3,240.03
	51243	123805	9/9/X9	111.32	675-83	✓	6 <u>6,233.61</u>
	41193	21390	9/20/X9	27.81	850-38	✓	Total 82,017.22
	51193	1668	9/12/X9	21.00	850-38	✓	8,000.00 X
	51193	1968	9/14/X9	17.17	850-38	✓	(413.89) P
	833057	39B3057Sb	9/27/X9	85.91	999-31	✓	<u>89,603.33</u> A
	832925	18416	9/23/X9	549.80	860-66	✓	Agrees to w/p BB
		234981	9/30/X9	185.00	900-60	✓	
	50789	331694	9/1/X9	1,347.26	145-59	✓	* Represents invoices dated before 10/14/X8 that did not get processed through the A/P system before the cutoff @ 10/14. Items are included in the 9/30/X8 A/P balance. See w/p BB
		1785711	9/21/X9	107.75	999-31	✓	✓ Examined invoice. Appears to be proper 9/30/X8 liability and account classification.
	51387	24708	9/8/X9	52.53	740-38	✓	A Per Janet, unrecorded liabilities decreased 30% from last year's \$125,312 due to a change in processing procedures for A/P. Instead of manually listing all invoices received before sending them to IT, IT enters info directly from document. This allows faster processing at y/e.
	832876	262688	9/22/X9	199.00	999-31	✓	X Amount represents 3 months of accrued unemployment compensation for July - Sept. It is billed quarterly and payment for 4th qtr 'X8 was not made @ 9/30. Amount appears reasonable compared to prior year Q4 billing.
	832876	62737	9/22/X9	199.00	999-31	✓	P Unexplained difference. Not material, no adjustment proposed.
	51312	8597	9/16/X9	273.00	950-18	✓	F Footed.
	51218	86821	9/23/X9	352.99	724-38	✓	
	51198	69411	9/22/X9	11.28	830-53	✓	
	51186	66642	8/31/X9	160.57	736-31	✓	
	51180	34946	9/22/X9	664.00	675-84	✓	
	51129	547567	9/14/X9	250.00	850-38	✓	
	51410	18686	9/29/X9	4,094.93	830-51	✓	
	51376	36772	9/29/X9	585.35	675-31	✓	
	50891	56TFI	9/10/X9	53.76	768-36	✓	
	51367	369029	9/30/X9	53.37	740-38	✓	
	50645	833146	9/30/X9	85.00	145-59	✓	
	48711	3157811	9/20/X9	13.36	144-06	✓	
		12782	9/22/X9	37.50	840-60	✓	
	45191	2017609	2/10/X9	4,328.85	675-38	✓	
	50401	264822	6/15/X9	1,090.79	675-84	✓	
	50784	28907	8/22/X9	1,550.00	675-84	✓	
	58342	97973	7/24/X9	1,134.00	675-82	✓	
	48206	9302260	9/30/X9	109.02	730-60	✓	
	50046	7971	9/28/X9	444.00	950-60	✓	
	50046	7729	8/26/X9	444.00	950-60	✓	
	50759	1712771	8/18/X9	17,800.00	675-84	✓	
	50759	1710232	8/17/X9	<u>1,190.00</u>	975-84	✓	
Page total				<u>37,505.27</u>			
				F			

NOTE TO PARTICIPANTS: The vendor names and other five pages of this workpaper have not been reproduced.

Your observations:

I. M. Well Memorial Hospital		W/P No. <b>B-7</b>				<b>PBC</b>	
9/30/X9		Prepared by: <b>RAR</b>				Date: <b>11/17/X9</b>	
		Reviewed by:				Date:	
a/c 983-86							
Summary of detail payments to BC/BS							
Blue Cross	246,960.00	<b>A</b>					
Blue Shield	199,020.00	<b>A</b>					
Settlement (BX) 3 quarters	30,294.39	<b>A</b>					
Settlement (BS)	(8,428.70)	<b>A</b>					
1st Quarter Batch 20X9	70,046.40	<b>A</b>					
2nd Quarter Batch 20X9	61,475.17	<b>A</b>					
3rd Quarter Batch 20X9	76,289.37	<b>A</b>					
4th Quarter Accrual 20X9	<u>80,000.00</u>	<b>A</b>					
	755,656.63						
Payments made by employees	(176,510.41)	Per client records					
Unreconciled difference	<u>2,588.33</u>	Passed; not material					
Balance @ 9/30/X9	<u>581,734.55</u>	*					
	<b>T/B      F</b>						
<b>A</b> Agreed to detail schedule							
<b>F</b> Footed							
* BC insurance expense has decreased approximately \$120,000 as compared to the year ended 9/30/X8.							



Your observations:

I. M. Well Memorial Hospital		W/P No. <b>CC-2</b>		<b>PBC</b>	
State Income Tax Withheld		Prepared by: <b>SRM</b>		Date: <b>11/2/X9</b>	
9/30/X9		Reviewed by:		Date:	
a/c 217-23					
Checks issued 10/13/X9:					
State A--check # 112262	38,638.35	✓			
State B--check # 112263	<u>6,582.78</u>	✓			
G/L Balance 9/30/X9	<u>45,221.13</u>	<b>F</b>			
	T/B 217-23				
Balance @ 9/30/X8	<u>35,822.29</u>				
<p>Note: The hospital remits withholding to the states on a monthly basis based on pay date to employees as opposed to the pay periods covered during the month. Consistent with prior years. (3 pay dates included above, same as prior year.)</p> <p>✓ Examined cancelled check dated 10/13/X8, agreeing check no., payee, and amount for September state income taxes. Check returned in 10/31/X8 bank statement.</p> <p><b>F</b> Footed.</p>					

Your observations:

I. M. Well Memorial Hospital			W/P No. <b>SI-1</b>			<b>PBC</b>	
Self-Insurance Fund Summary			Prepared by: <b>SRM</b>			Date: <b>11/15/X9</b>	
9/30/X9			Reviewed by:			Date:	
Acct. No.	Account Title	<u>9/30/X8</u>	<u>9/30/X9</u>				
153-01	Cash	2,780.64 <b>P</b>	929.63			<b>T/B 153-01</b>	
153-02	Investments	1,590,811.96 <b>P</b>	<u>1,753,561.59</u>	<b>T/B 153-02</b>		<b>From SI-1/11</b>	
279-01	Fund Balance	<u>(1,593,592.60)</u> <b>P</b>		<u>1,754,491.22</u>	<b>* From SI-2</b>		
		<u>0</u> <b>F</b>	<u>1,754,491.22</u>	<u>1,754,491.22</u>	<b>T/B 279-01</b>		
				<b>F</b>			
<b>P</b> Amounts traced to 9/30/X8 w/ps							
<b>F</b> Footed							
<b>*</b> Minimum balance should be \$1,620,920							

I. M. Well Memorial Hospital			W/P No. <b>SI-2</b> Prepared by: <b>SRM</b> Reviewed by:  Date: <b>11/15/X9</b> Date:			
Self-Insurance Fund--Fund Balance						
9/30/X9						
a/c 279-01						
Fund Balance (per 9/30/X8 w/ps)				1,593,592.60		
Add:						
Interest income	187,644.25	<b>B</b>				
Deposits from the hospital	0.00	<b>A</b>		187,644.25		
				1,781,236.85		
Deduct:						
Trustee fees	7,886.00	✓				
Actuarial fees	3,200.00	✓				
Insurance fund costs--attorney fees	13,063.89	✓				
Paid to hospital for attorney fees	1,095.74	✓				
Claims paid	1,500.00	✓		26,745.63		
Fund Balance 9/30/X9				1,754,491.22	<b>F</b>	
				To SI-1		
<b>F</b> Footed						
✓ Inspected invoices or other supporting documentation						
<b>A</b> No contribution this year because fund is overfunded. See actuary report in permanent file.						
<b>B</b> Interest income reasonableness test:						
Investment balance 9/30/X8	1,590,812					
Investment balance 9/30/X9	1,753,562					
	3,344,374					
Divide by 2	2					
Average investment balance	1,672,187					
Interest income 20X9	187,644					
Divided by average investment balance	1,672,187					
Average rate of return	11.22%					

Your observations:

# Summary

This chapter discussed and illustrated the typical shortcomings in working papers.





## Appendix A

# **4 STRATEGIES FOR EFFICIENT, EFFECTIVE AUDIT DOCUMENTATION**

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This appendix is included for supplementary purposes only and is not required for CPE credit.



## 4 strategies for efficient, effective audit documentation

Smart planning and standardized procedures can aid in compliance.

By Mark Koziel, CPA, CGMA

November 1, 2017



Photo by Radachynskyi/iStock

Documenting the nature, timing, extent, and results of your procedures may seem as if it will break your audit budget, but many practitioners have found that this isn't the case. An AICPA study found that the most common audit issue is a lack of adequate documentation.

Strong documentation will enable you to comply with AU-C Section 230, *Audit Documentation*, and it also can lead to a more efficient engagement. The time spent documenting in accordance with the standard is an investment that will pay dividends later. Complying with the requirements of the *Audit Documentation* standard while implementing the best practices discussed here will help your firm perform high-quality work while increasing your efficiency.

### TAKE A SMART APPROACH TO PLANNING

A sound audit plan is the foundation of an efficient and effective audit. When performing your planning procedures, take the time to really get to know clients and what is going on in their industry. Make sure the most experienced engagement team members are heavily involved in identifying audit risks and responses.

Once the audit plan has been established, map the audit in a memo, laying out the biggest risks, strategies to mitigate each risk, and references to where the work will be performed. This will give the partner a quick overview of the audit areas that matter the most while providing linkage to the working papers. Continue to update the memo as the audit

progresses and new risks are identified.

Referencing the audit plan, ensure that your audit programs have been tailored to address your client's unique risks. For firms that use standardized materials from third-party providers, actively eliminating procedures that aren't necessary to support the audit opinion can increase efficiency while focusing the audit team's attention on the accounts and areas that represent the greatest risk.

If your firm's audit teams have been taking a SALY ("same as last year") approach—or worse, if they have been performing whatever procedures appear on a third-party provider's audit program regardless of risk considerations—they may be missing an opportunity to make significant gains in efficiency and effectiveness.

## **EMBRACE STANDARDIZATION**

Although firms may have standardized audit procedures, each partner often has his or her own working paper preferences, which can create inefficiencies when staff members document their work. The solution is to require that all auditors use standardized working papers. To ensure proper documentation, use a format designed to comply with AU-C Section 230, covering the nature, extent, and timing of procedures; the results of those procedures; and any significant findings, issues, or professional judgments.

Firms should use standardized tick marks to avoid unnecessary repetition in the working papers. They should also design working papers to accomplish multiple purposes. For example, firms can use the same working paper to analyze a balance sheet account and related income statement accounts (e.g., fixed assets and depreciation expense) as well as provide necessary information for the entity's statement of cash flows (e.g., fixed asset additions and disposals), required disclosures (e.g., depreciation schedule), and/or tax return.

Eliminating unnecessary client documentation in the file boosts efficiency as well. For example, when an auditor adds copies of client bank statements to an audit file, he or she must scan in the documents, link pertinent information to the bank reconciliation, and obtain a supervisor's signoff. This is time-consuming, and it could lead to legal exposure. Remember: Not every audit procedure needs its own working paper. The nature, timing, extent, and results of some procedures can be documented by adding a few sentences to the audit program.

## **DOCUMENT NOW, SAVE TIME LATER**

Instead of documenting while performing the audit procedures, auditors in the field sometimes decide to catch up with documentation later. However, there is a good reason that the standard calls for completing this step promptly. Documentation is more likely to be accurate if it is performed sooner rather than later. This approach also prevents the preparer from having to remember vast amounts of information or to repeat tasks after the procedure is performed.

In addition, meeting the requirements of AU-C Section 230 by documenting in a timely manner allows supervisors and partners to spend less time dealing with unnecessary questions and misunderstandings. It improves the chances that working papers can be reviewed in the field and that a draft report and management letter can be ready before leaving the client's office. It's much easier to identify problems and address questions to client staff when you're working down the hall from them than after you've left the field and you're trying to tie up loose ends.

Completing the review process and issuing the audit report on a timely basis also limits the auditor's responsibility for subsequent events procedures. When audit work is done on March 31, but the report is not issued until September, the auditor must consider events that have taken place in the meantime. That could require meeting with the client and performing various procedures to ensure that nothing has occurred that should be included in the financial statement disclosures. Timely completion of the report prevents these additional steps.

## **BE PREPARED FOR WHAT'S AHEAD**

Good documentation also improves efficiency in subsequent-year audits. By documenting appropriately, the auditor is providing next year's audit team with a record of matters of continuing significance, helping them avoid duplication of effort, and giving them a solid foundation on which to build. They can walk in with a better understanding of what's ahead and the information that is needed, and they don't have to start from scratch.

Auditors will also be in better shape when it comes to internal inspections, peer reviews, and regulatory inspections. With more thorough documentation, less time should be spent addressing questions and concerns during reviews or inspections. By developing a cohesive set of working papers, the auditor is less likely to be required to redo work already performed in the field, make follow-up requests to clients, or, in a worst-case situation, recall an audit report.

### About the author

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### AICPA resources

#### Articles

- "How Well Do You Know Audit Documentation Requirements?" (<https://www.journalofaccountancy.com/news/2017/aug/audit-documentation-requirements-quiz.html>)" *JofA*, Aug. 1, 2017
- "Audit Documentation: Tips for Getting It Right" (<https://www.journalofaccountancy.com/issues/2017/jun/audit-documentation.html>)," *JofA*, June 2017
- "ASB Issues New Going Concern Auditing Standard" (<https://www.journalofaccountancy.com/news/2017/feb/new-asb-going-concern-auditing-standard-201715982.html>)," *JofA*, Feb. 22, 2017
- "Professional Liability Spotlight: Professional Liability Risk Resolutions for 2017" (<https://www.journalofaccountancy.com/issues/2017/jan/liability-risk-resolutions-for-2017.html>)," *JofA*, Jan. 2017
- "Maintaining Independence With Nonattest Services" (<https://www.journalofaccountancy.com/issues/2016/nov/maintaining-independence-with-nonattest-services.html>)," *JofA*, Nov. 2016

#### CPE self-study

- Audit Workpapers: Documenting and Reviewing Field Work (#733328, text; #GT-AUDW, group pricing)
- Audit Workpapers: Documenting Field Work (#163223, online access; #GT-CL4DFW, group pricing)
- Audit Workpapers: Reviewing Field Work Documentation (#163233, online access; #GT-CL4FWD, group pricing)
- New Staff: Core Concepts—Workpapers and Workpaper Documentation (#161060, online access; #GT-JEH, group pricing)
- Working Paper Documentation—Tax Staff Essentials (#157603, online access; #GT-TSE.WPD, group pricing)

For more information or to make a purchase, go to [aicpastore.com](http://www.aicpastore.com) (<http://www.aicpastore.com>) or call the Institute at 888-777-7077.

#### Online resources

- [Employee Benefit Plan Audit Quality Center](http://www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Pages/default.aspx)  
(<http://www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Pages/default.aspx>)
  - [Governmental Audit Quality Center](http://www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/default.aspx)  
(<http://www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/default.aspx>)
  - [Peer Review Audit Documentation Resources webpage](http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/Pages/peer-review-documentation-resources.aspx)  
(<http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/Pages/peer-review-documentation-resources.aspx>) (includes free toolkit)
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## Appendix B

# **AUDIT DOCUMENTATION: TIPS FOR GETTING IT RIGHT**

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This appendix is included for supplementary purposes only and is not required for CPE credit.





## Audit documentation: Tips for getting it right

A successful engagement hinges on avoiding 3 common misconceptions.

By Ahava Z. Goldman, CPA, CGMA; Charles E. Landes, CPA; and Carl R. Mayes Jr., CPA

June 1, 2017



Photo by artfoliophoto/iStock

For many staff auditors, the very mention of working paper review is enough to make their hair stand on end. No matter how thoroughly they perform an audit procedure, they know if their documentation does not reflect what they've done, they can expect review comments from their supervisor.

This is a vital lesson that is instilled in auditors from the beginning of their careers: Insufficient documentation represents a failure to comply with generally accepted auditing standards (GAAS). That lesson has never been more relevant than it is today.

Starting in 2014, the AICPA Peer Review Program has performed what are called "enhanced oversights." Through these oversights, subject-matter experts from public practice review a sample of engagements after they have been subject to peer review. The AICPA then tracks the number of engagements that did not conform to applicable professional standards in all material respects (commonly referred to as "materially nonconforming" engagements).

The experts have found high levels of material nonconformity, and the most common cause has been noncompliance with AU-C Section 230, *Audit Documentation*. In fact, *one out of every four engagements* subject to these enhanced oversights by the Peer Review Program was materially nonconforming due to a lack of adequate audit documentation.

### WHAT WE'VE LEARNED

By collecting information from the firms subject to enhanced oversight, we've learned that three common misconceptions are driving nonconformity. They are:

- Auditors can meet their overall audit objectives without documenting their work;
- A signoff on an audit program is sufficient documentation of a detail test; and
- Oral explanation can substitute for written documentation to meet the requirements of AU-C Section 230.

Let's examine these one at a time:

#### **Misconception No. 1: Auditors can meet their overall audit objectives without documenting their work**

Through enhanced oversight, numerous firms have expressed their belief that sufficient evidence to support the audit opinion can be obtained without meeting the requirements of AU-C Section 230.

For example, on one of the single-audit engagements subject to enhanced oversight, the engagement team had no documentation related to their tests of controls over compliance. When the subject-matter expert concluded that the engagement was materially nonconforming, the engagement partner disagreed. He explained to the expert that because the required tests had been performed, he reasoned, he had done enough to support the audit opinion.

This is not an appropriate reading of the requirements of GAAS.

Under AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, obtaining sufficient appropriate audit evidence is necessary to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

Meeting the requirements of AU-C Section 230, and the specific documentation requirements of other relevant AU-C sections, provides evidence of the auditor's basis for his or her audit opinion as well as evidence that the audit was planned and performed in accordance with GAAS, according to paragraph .02 of AU-C Section 230.

If sufficient appropriate audit evidence necessary to support the audit opinion was not appropriately documented, then the audit was not conducted in accordance with GAAS and the auditor would not have a basis to render an opinion.

In such instances, the auditor should take appropriate action under AU-C Section 585, *Consideration of Omitted Procedures After the Report Release Date*. This includes assessing the effect of omitted procedures on the auditor's ability to support the audit opinion and may include performing the omitted procedures or alternative procedures. Omitted procedures may include documenting procedures in accordance with AU-C Section 230 that had been performed but not previously documented along with the evidence obtained from those procedures.

#### **Misconception No. 2: A signoff on an audit program is sufficient documentation of a detail test**

The Peer Review team identified numerous instances in which the auditor believed a signoff on an audit program was sufficient documentation of a detail test. For example, on an audit of a defined contribution plan, one auditor believed he had met the requirements for documenting his testing of participant eligibility by signing off on the program step relative to that test even though there was no documentation of the evidence obtained.

Signing off on an audit program is rarely sufficient to meet the requirements of the *Audit Documentation* standard. In accordance with paragraph .08 of AU-C Section 230, the auditor should document:

- The nature, timing, and extent of the procedures performed;

- The results of the procedures and the evidence obtained; and
- Significant findings or issues arising during the audit, the conclusions reached thereon, and any significant professional judgments made in reaching those conclusions.

These should be documented for *any procedure* that provides audit evidence that is necessary to support the audit opinion.

In some cases, a signoff on an audit program might address the nature of the procedure, who performed it, who reviewed it, and maybe the timing of the procedure. The other requirements of the standard, however, would ordinarily not be met.

### **Misconception No. 3: Oral explanation can substitute for written documentation to meet the requirements of AU-C Section 230**

Another common finding in the enhanced oversights was the reliance of auditors and peer reviewers on oral explanation as a substitute for written documentation to meet the requirements of AU-C Section 230.

As AU-C Section 230, paragraph .A7 notes, if the auditor meets the requirements of AU-C Section 230 but clarification is needed, oral explanation may be used to provide that clarification.

For example, if the results of an auditor's procedures and the auditor's conclusion with respect to those procedures appear inconsistent to a third-party reviewer, the auditor may use oral explanation to supplement his or her documentation.

However, expert oversight uncovered numerous instances in which oral explanation was relied on inappropriately.

For example, when reviewing a single audit, one peer reviewer noted that a firm failed to document its consideration of direct and material compliance requirements. The reviewer discussed the matter with the firm, and he concluded that the engagement team had complied with applicable professional standards based on oral explanation. However, there was no documented evidence that the engagement team had performed this required procedure.

If an auditor performs a procedure that provides audit evidence that is necessary to support the audit opinion, and the auditor's documentation of that evidence does not meet the requirements of AU-C Section 230, the auditor has not complied with GAAS, and no amount of oral explanation can serve as a substitute.

## **HOW TO RAISE QUALITY IN YOUR PRACTICE**

Auditors seeking to identify and address potential documentation deficiencies in their practice should review AU-C Section 230 and use the free resources available on the AICPA Peer Review team's Audit Documentation Resources page at [aicpa.org/documentation](http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/Pages/peer-review-documentation-resources.aspx) (<http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/Pages/peer-review-documentation-resources.aspx>). Using these resources, the firm can:

- Train its personnel on the *Audit Documentation* standard using a PowerPoint presentation with speaker notes;
- Facilitate proper consideration of documentation matters during the firm's internal inspection;
- Provide personnel with sample working papers from the AICPA; and
- Use practice aids from the Governmental and Employee Benefit Plan Audit Quality Centers, which address the most common documentation issues detected in enhanced oversights.

## About the authors

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## AICPA resources

### Articles

- "AICPA Issues New Going Concern Auditing Standard (<http://www.journalofaccountancy.com/news/2017/feb/new-asb-going-concern-auditing-standard-201715982.html>)," *JofA*, Feb. 22, 2017
- "Professional Liability Spotlight: Professional Liability Risk Resolutions for 2017 (<http://www.journalofaccountancy.com/issues/2017/jan/liability-risk-resolutions-for-2017.html>)," *JofA*, Jan. 2017
- "Maintaining Independence With Nonattest Services (<http://www.journalofaccountancy.com/issues/2016/nov/maintaining-independence-with-nonattest-services.html>)," *JofA*, Nov. 2016
- "11 Tips for Success With Single Audits (<http://www.journalofaccountancy.com/issues/2016/nov/single-audits.html>)," *JofA*, Nov. 2016

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- Governmental Audit Quality Center, [aicpa.org/gaqc](http://www.aicpa.org/gaqc) (<http://www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/default.aspx>)
- Audit Documentation Resources, [aicpa.org/documentation](http://www.aicpa.org/documentation) (<http://www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/Pages/peer-review-documentation-resources.aspx>)

## Appendix C

# AUDIT DOCUMENTATION QUIZ

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**This appendix is provided for supplementary purposes only and is not required reading for this course or earning the related CPE credits.**



# Journal of accountancy

How well do you know audit documentation requirements? By Carl R. Mayes Jr., CPA August 1, 2017  
Through its Enhanced Oversight Program, the AICPA Peer Review Program has found that the most common cause of material nonconformity in audits is noncompliance with AU-C section 230, Audit Documentation. In fact, the subject-matter experts from public practice who performed the oversights found that one out of every four engagements reviewed is materially nonconforming due to a lack of adequate audit documentation. Do you know what the documentation standard requires?

Take this quiz to find out.

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## Question 1

Auditors can meet their overall audit objectives and support their audit opinion without documenting their work.

- a. True
- b. False

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## Question 2

Ordinarily, a sign-off on an audit program is sufficient documentation of a detail test.

- a. True
- b. False

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## Question 3

Oral explanation can substitute for written documentation to meet the requirements of the Audit Documentation standard.

- a. True
- b. False

---

## Question 4

When auditing a smaller, less complex entity:

- a. The auditor may substitute oral explanation for documenting the nature, timing, extent, and results of audit procedures necessary to support the audit opinion.
- b. The auditor is required to document the nature of audit procedures necessary to support the audit opinion but not the timing, extent, or results.
- c. The auditor is required to document the nature, timing, extent, and results of the audit procedures necessary to support the audit opinion.
- d. None of the above.

---

## Question 5

An auditor's documentation of the test of a note receivable includes dated signoffs from the preparer and reviewer, as well as the note: "Obtained note receivable. Tested existence, rights, and valuation assertions." Which of the following is true?

- a. The auditor documented the nature and extent of the procedures in accordance with AU-C Section 230 but not the timing or results.
- b. The auditor documented the timing of the procedures in accordance with AU-C Section 230 but not the nature, extent, or results.
- c. The auditor documented the results of the procedures in accordance with AU-C Section 230 but not the nature, extent, or timing.
- d. The auditor documented the nature, timing, extent, and results of the procedures in accordance with AU-C Section 230.

---

## ANSWERS

### Question 1 - B

Through enhanced oversights, numerous firms have expressed their belief that sufficient evidence to support the audit opinion can be obtained without meeting the requirements of AU-C Section 230. This is not an appropriate reading of the requirements of GAAS.

Under AU-C Section 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards, obtaining sufficient appropriate audit evidence is necessary to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base an opinion.

Meeting the requirements of AU-C Section 230 and the specific documentation requirements of other relevant AU-C sections provides evidence of the auditor's basis for his or her audit opinion as well as



evidence that the audit was planned and performed in accordance with GAAS, according to paragraph .02 of AU-C Section 230.

If sufficient appropriate audit evidence necessary to support the audit opinion was not appropriately documented, then the audit was not conducted in accordance with GAAS, and the auditor would not have a basis to render an opinion.

### **Question 2 - B**

The Peer Review team identified numerous instances in which the auditor believed a sign-off on an audit program was sufficient documentation of a detail test. Signing off on an audit program is rarely sufficient to meet the requirements of the Audit Documentation standard.

In accordance with paragraph .08 of AU-C Section 230, the auditor should document:

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

In some cases, a sign-off on an audit program might address the nature of the procedure, who performed it, who reviewed it, and maybe the timing of the procedure. The other requirements of the standard, however, would ordinarily not be met.

### **Question 3 - B**

Another common finding in the enhanced oversights was the reliance of auditors and peer reviewers on oral explanation as a substitute for written documentation to meet the requirements of AU-C Section 230.

As AU-C Section 230, paragraph .A7, notes, if the auditor meets the requirements of AU-C Section 230, but clarification is needed, oral explanation may be used to provide that clarification. For example, if the results of an auditor's procedures and the auditor's conclusion with respect to those procedures appear inconsistent to a third-party reviewer, the auditor may use oral explanation to supplement his or her documentation.

However, oversights uncovered numerous instances in which oral explanation was relied upon inappropriately. If an auditor performs a procedure that provides audit evidence that is necessary to support the audit opinion, and the auditor's documentation of that evidence does not meet the requirements of AU-C Section 230, the auditor has not complied with GAAS, and no amount of oral explanation can serve as a substitute.

### **Question 4 - C**

The auditor is required to document the nature, timing, extent, and results of the audit procedures necessary to support the audit opinion.

AU-C Section 230, paragraph .A19, states: "The audit documentation for the audit of a smaller, less complex entity is generally less extensive than that for the audit of a larger, more complex entity." This is

because, when performing audits of less complex entities, the auditor may encounter fewer audit risks. As such, there may be fewer procedures to perform and less documentation in the audit file.

However, regardless of the size of the entity or its level of complexity, the auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level, and that evidence must be documented in accordance with AU-C Section 230. Required documentation includes (but is not limited to) the nature, timing, extent, and results of the audit procedures necessary to support the audit opinion.

#### **Question 5 - B**

In this example, the auditor documented the timing of the procedures. Both the preparer and the reviewer have signed off and dated, so an experienced auditor, having no previous connection with the audit, would understand who did the work, who reviewed it, and when it happened. While the auditor documented the assertions that were tested, there is no indication of how those assertions were tested or what results were noted.

# Accounting and Auditing Glossary

**Account** – Formal record that represents, in words, money or other unit of measurement, certain resources, claims to such resources, transactions or other events that result in changes to those resources and claims.

**Account payable** – Amount owed to a creditor for delivered goods or completed services.

**Account receivable** – Claim against a debtor for an uncollected amount, generally from a completed transaction of sales or services rendered.

**Accountants' report** – Formal document that communicates an independent accountant's (1) expression of limited assurance on financial statements as a result of performing inquiry and analytic procedures (Review Report); (2) results of procedures performed (type of Attestation Report); (3) non-expression of opinion or any form of assurance on a presentation in the form of financial statements information that is the representation of management (Compilation Report); or (4) an opinion on an assertion made by management in accordance with the Statements on Standards for Attestation Engagements (Attestation Report). An accountant's report does not result from the performance of an audit.

**Accounting** – Recording and reporting of financial transactions, including the origination of the transaction, its recognition, processing, and summarization in the financial statements.

**Accounting change** – Change in (1) an accounting principle; (2) an accounting estimate; or (3) the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.

**Accrual basis** – Method of accounting that recognizes revenue when earned, rather than when collected. Expenses are recognized when incurred rather than when paid.

**Accrued expense** – An expense incurred during an accounting period for which payment is not due until a later accounting period. This results from the purchase of services which at the time of accounting have only been partly performed, are not yet billable, or have not been paid for.

**Accumulated depreciation** – Total depreciation pertaining to an asset or group of assets from the time the assets were placed in service until the date of the financial statement or tax return. This total is the contra account to the related asset account.

**Additional paid in capital** – Amounts paid for stock in excess of its par value or stated value. Also, other amounts paid by stockholders and charged to equity accounts other than capital stock.

**Adjusting entries** – Accounting entries made at the end of an accounting period to allocate items between accounting periods.

**Amortization** – The process of reducing a recognized liability systematically by recognizing revenues or by reducing a recognized asset systematically by recognizing expenses or costs. In accounting for postretirement benefits, amortization also means the systematic recognition

in net periodic postretirement benefit cost over several periods of amounts previously recognized in other comprehensive income, that is, gains or losses, prior service cost or credits, and any transition obligation or asset.

**Analytical procedures** – Substantive tests of financial information which examine relationships among data as a means of obtaining evidence. Such procedures include (1) comparison of financial information with information of comparable prior periods; (2) comparison of financial information with anticipated results (e.g., forecasts); (3) study of relationships between elements of financial information that should conform to predictable patterns based on the entity's experience; and (4) comparison of financial information with industry norms.

**Annual report** – The annual report to shareholders is the principal document used by most public companies to disclose corporate information to their shareholders. It is usually a state-of-the-company report, including an opening letter from the Chief Executive Officer, financial data, results of continuing operations, market segment information, new product plans, subsidiary activities, and research and development activities on future programs. The Form 10-K, which must be filed with the SEC, typically contains more detailed information about the company's financial condition than the annual report.

**Assertion** – Explicit or implicit representations by an entity's management that are embodied in financial statement components and for which the auditor obtains and evaluates evidential matter when forming his/her opinion on the entity's financial statements.

**Audit risk** – The risk that the auditor may unknowingly fail to modify appropriately his/her opinion on financial statements that are materially misstated.

**Audit sampling** – Application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.

**Auditors' report** – Written communication issued by an independent certified public accountant (CPA) describing the character of his/her work and the degree of responsibility taken. An auditor's report includes a statement that the audit was conducted in accordance with generally accepted auditing standards (GAAS), which require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, as well as a statement that the auditor believes the audit provides a reasonable basis for his/her opinion.

**Bad debt** – All or portion of an account, loan, or note receivable considered to be uncollectible.

**Balance sheet** – Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation of a specified date the entity's assets, liabilities, and the equity of its owners. Also known as a statement of financial condition.

**Bond** – One type of long-term promissory note, frequently issued to the public as a security regulated under federal securities laws or state blue sky laws. Bonds can either be registered in the owner's name or are issued as bearer instruments.

**Book value** – Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as carrying value.

**Business combinations** – Combining of two entities. Under the purchase method of accounting, one entity is deemed to acquire another and there is a new basis of accounting for the assets and liabilities of the acquired company.

**Business segment** – Any division of an organization authorized to operate, within prescribed or otherwise established limitations, under substantial control by its own management.

**Capital stock** – Ownership shares of a corporation authorized by its articles of incorporation. The money value assigned to a corporation's issued shares. The balance sheet account with the aggregate amount of the par value or stated value of all stock issued by a corporation.

**Capitalized cost** – Expenditure identified with goods or services acquired and measured by the amount of cash paid or the market value of other property, capital stock, or services surrendered. Expenditures that are written off during two or more accounting periods.

**Carrying value** – Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as book value.

**Cash basis** – A special purpose framework in which revenues and expenditures are recorded when they are received and paid.

**Cash equivalents** – Short-term (generally less than three months), highly liquid investments that are convertible to known amounts of cash.

**Cash flows** – Net of cash receipts and cash disbursements relating to a particular activity during a specified accounting period.

**Casualty loss** – Sudden property loss caused by theft, accident, or natural causes.

**Change in engagement** – A request, before the completion of the audit (review), to change the engagement to a review or compilation (compilation) of financial statements.

**Class actions** – A federal securities class action is a court action filed on behalf of a group of shareholders under Rule 23 of the Federal Rules of Civil Procedure. Instead of each shareholder bringing an individual lawsuit, one or more shareholders bring a class action for the entire class of shareholders.

**Common stock** – Capital stock having no preferences generally in terms of dividends, voting rights, or distributions.

**Companies, going public** – Companies become public entities for different reasons, but usually to raise additional capital. The SEC has prepared a guide for companies – Q&A: Small Business and the SEC – that provides a basic understanding about the various ways companies can become public and what securities laws apply. The SEC also has a list of some of the registration and reporting forms and related regulations that pertain to small and large companies.

**Comparative financial statement** – Financial statement presentation in which the current amounts and the corresponding amounts for previous periods or dates also are shown.

**Compilation** – Presentation in the form of financial statements information that is the representation of management (owners) without the accountant's assurance as to conformity with generally accepted accounting principles (GAAP).

**Comprehensive income** – Change in equity of a business entity during a period from transactions and other events and circumstances from nonowner sources. The period includes all changes in equity except those resulting from investments by owners and distributions to owners.

**Confirmation** – Auditor's receipt of a written or oral response from an independent third party verifying the accuracy of information requested.

**Consolidated financial statements** – Combined financial statements of a parent company and one or more of its subsidiaries as one economic unit.

**Consolidation** – The presentation of a single set of amounts for an entire reporting entity. Consolidation requires elimination of intra-entity transactions and balances.

**Contingent liability** – Potential liability arising from a past transaction or a subsequent event.

**Continuing accountant** – An accountant who has been engaged to audit, review, or compile and report on the financial statements of the current period and one or more consecutive periods immediately prior to the current period.

**Control risk** – Measure of risk that errors exceeding a tolerable amount will not be prevented or detected by an entity's internal controls.

**Controls tests** – Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial report.

**Current asset** – Asset that one can reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle, or within a year if more than one cycle is completed each year.

**Current liability** – Obligation whose liquidation is expected to require the use of existing resources classified as current assets, or the creation of other current liabilities.

**Current value** – (1) Value of an asset at the present time as compared with the asset's historical cost. (2) In finance, the amount determined by discounting the future revenue stream of an asset using compound interest principles.

**Debt** – General name for money, notes, bonds, goods, or services which represent amounts owed.

**Definite criteria** – A special purpose framework using a definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

**Depreciation** – Expense allowance made for wear and tear on an asset over its estimated useful life.

**Derivatives** – Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security or index. For example, a stock option is a derivative because its value changes in relation to the price movement of the underlying stock.

**Detection risk** – Risk that the auditor will not detect a material misstatement.

**Disclosure** – Process of divulging accounting information so that the content of financial statements is understood.

**Discount** – Reduction from the full amount of a price or debt.

**Dividends** – Distribution of earnings to owners of a corporation in cash, other assets of the corporation, or the corporation's capital stock.

**Earnings per share (EPS)** – The amount of earnings attributable to each share of common stock. For convenience, the term is used to refer to either earnings or loss per share.

**Employee stock options plans** – An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan. Employee Stock Options Plans should not be confused with the term "ESOPs," or Employee Stock Ownership Plans, which are retirement plans.

**Employee stock ownership plans (ESOPs)** – An employee stock ownership plan (ESOP) is a retirement plan in which the company contributes its stock to the plan for the benefit of the company's employees. With an ESOP, you never buy or hold the stock directly. This type of plan should not be confused with employee stock options plans, which are not retirement plans. Instead, employee stock options plans give the employee the right to buy their company's stock at a set price within a certain period of time.

**Equity** – Residual interest in the assets of an entity that remains after deducting its liabilities. Also, the amount of a business' total assets, less total liabilities. Also, the third section of a balance sheet, the other two being assets and liabilities.

**Equity security** – Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example, put options) an ownership interest in an entity at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

**Error** – Act that departs from what should be done; imprudent deviation, unintentional mistake or omission.

**Executive compensation: Where to find in SEC reports** – The federal securities laws require clear, concise and understandable disclosure about compensation paid to CEOs and certain other high-ranking executive officers of public companies. You can locate information about executive pay in (1) the company's annual proxy statement; (2) the company's annual report on Form 10-K; and (3) registration statements filed by the company to register securities for sale to the public.

**Expenditures** – Expenditures to which capitalization rates are to be applied are capitalized expenditures (net of progress payment collections) for the qualifying asset that have required the payment of cash, the transfer of other assets, or the incurring of a liability on which interest is recognized (in contrast to liabilities, such as trade payables, accruals, and retainages on which interest is not recognized).

**Extraordinary items** – Events and transactions distinguished by their unusual nature and by the infrequency of their occurrence. Extraordinary items are reported separately, less applicable income taxes, in the entity's statement of income or operations.

**Fair disclosure, regulation FD** – On August 15, 2000, the SEC adopted Regulation FD to address the selective disclosure of information by companies and other issuers. Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities – generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information – the issuer must make public disclosure of that information. In this way, the new rule aims to promote the full and fair disclosure.

**Fair market value** – Price at which property would change hands between a buyer and a seller without any compulsion to buy or sell.

**Federal securities laws** – The laws that govern the securities industry, include the Securities Act of 1933; Securities Exchange Act of 1934; Investment Company Act of 1940; Investment Advisers Act of 1940; and Public Utility Holding Company Act of 1935.

**Financial statements** – Presentation of financial data including balance sheets, income statements and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time and its results of operations for a period then ended.

**First in, first out (FIFO)** – Accounting method of valuing inventory under which the costs of the first goods acquired are the first costs charged to expense. Commonly known as FIFO.

**Fiscal year** – Period of 12 consecutive months chosen by an entity as its accounting period which may or may not be a calendar year.

**Fixed asset** – Any tangible asset with a life of more than one year used in an entity's operations.

**Foreign currency translation** – Restating foreign currency in equivalent dollars; unrealized gains or losses are postponed and carried in Stockholder's Equity until the foreign operation is substantially liquidated.



**Form 10-K** – This is the report that most publicly traded companies file with the SEC on an annual basis. It provides a comprehensive overview of the company's business and financial condition. Some companies choose to send their Form 10-K to their shareholders instead of sending a separate annual report. Currently, Form 10-K must be filed with the SEC within 90 days after the end of the company's fiscal year.

**Form 10-Q** – The Form 10-Q is a report filed quarterly by most reporting companies. It includes unaudited financial statements and provides a continuing view of the company's financial position during the year. The report must be filed for each of the first three fiscal quarters of the company's fiscal year and is currently due within 45 days of the close of the quarter. In addition to Form 10-Q, companies provide annual reports to their shareholders and file Form 10-K on an annual basis with the SEC.

**Form 8-K** – This is the "current report" used to report material events or corporate changes that have previously not been reported by the company in a quarterly report (Form 10-Q) or annual report (Form 10-K).

**Forms 3, 4, 5** – Corporate insiders-meaning a company's officers and directors, and any beneficial owners of more than 10% of a class of the company's equity securities registered under Section 12 of the Securities Exchange Act of 1934 – must file with the SEC a statement of ownership regarding those securities. The initial filing is on Form 3. Changes in ownership are reported on Form 4. Insiders must file a Form 5 to report any transactions that should have been reported earlier on a Form 4 or were eligible for deferred reporting.

**Fraud** – Willful misrepresentation by one person of a fact inflicting damage on another person.

**Gain** – Excess of revenues received over costs relating to a specific transaction.

**General ledger** – Collection of all assets, liability, owners' equity, revenue, and expense accounts.

**Generally accepted accounting principles (GAAP)** – Conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The highest level of such principles is set by the Financial Accounting Standards Board (FASB).

**Generally accepted auditing standards (GAAS)** – Standards set by the American Institute of Certified Public Accountants (AICPA) which concern the auditor's professional qualities and judgment in the performance of his/her audit and in the actual report.

**Going concern** – Assumption that a business can remain in operation long enough for all of its current plans to be carried out.

**Going private** – A company "goes private" when it reduces the number of its shareholders to fewer than 300 and is no longer required to file reports with the SEC.

**Goodwill** – An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not for profit entity that are not individually identified and separately recognized.

**Gross income** – A tax term meaning all income from whatever source derived, except as otherwise provided in the income tax code.

**Guaranty** – Legal arrangement involving a promise by one person to perform the obligations of a second person to a third person, in the event the second person fails to perform.

**Hedges** – Protect an entity against the risk of adverse price or interest-rate movements on its assets, liabilities, or anticipated transactions. A hedge is used to avoid or reduce risks by creating a relationship by which losses on positions are counterbalanced by gains on separate positions in another market.

**Historical cost** – The generally accepted method of accounting used in the primary financial statements that is based on measures of historical prices without restatement into units, each of which has the same general purchasing power.

**Income** – Inflow of revenue during a period of time.

**Income statement** – Summary of the effect of revenues and expenses over a period of time.

**Income tax basis** – A special purpose framework that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.

**Initial public offerings (IPO)** – IPO stands for initial public offering and occurs when a company first sells its shares to the public.

**Initial public offerings, lockup agreements** – Lockup agreements prohibit company insiders – including employees, their friends and family, and venture capitalists – from selling their shares for a set period of time. In other words, the shares are “locked up.” Before a company goes public, the company and its underwriter typically enter into a lockup agreement to ensure that shares owned by these insiders do not enter the public market too soon after the offering.

**Insider trading** – “Insider trading” actually includes both legal and illegal conduct. The legal version is when corporate insiders – officers, directors, and employees – buy and sell stock in their own companies. Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include “tipping” such information, securities trading by the person “tipped,” and securities trading by those who misappropriate such information.

**Intangible asset** – Asset having no physical existence such as trademarks and patents.

**Interest** – Payment for the use or forbearance of money.

**Interim financial statements** – Financial statements that report the operations of an entity for less than one year.

**Internal control** – Process designed to provide reasonable assurance regarding achievement of various management objectives such as the reliability of financial reports.

**Inventory** – Tangible property held for sale, or materials used in a production process to make a product.

**Investment** – Expenditure used to purchase goods or services that could produce a return to the investor.

**Journal** – Any book containing original entries of daily financial transactions.

**Last in, first out (LIFO)** – Accounting method of valuing inventory under which the costs of the last goods acquired are the first costs charged to expense. Commonly known as LIFO.

**Lease** – Conveyance of land, buildings, equipment, or other assets from one person (Lessor) to another (Lessee) for a specific period of time for monetary or other consideration, usually in the form of rent.

**Leasehold** – Property interest a lessee owns in the leased property.

**Ledger** – Any book of accounts containing the summaries of debit and credit entries.

**Lessee** – Person or entity that has the right to use property under the terms of a lease.

**Lessor** – Owner of property, the temporary use of which is transferred to another (lessee) under the terms of a lease.

**Liability** – Debts or obligations owed by one entity (Debtor) to another entity (Creditor) payable in money, goods, or services.

**Listing and delisting requirements** – Before a company can begin trading on an exchange or the Nasdaq Stock Market, it must meet certain initial requirements or “listing standards.” The exchanges and the Nasdaq Stock Market set their own standards for listing and continuing to trade. The SEC does not set listing standards. The initial listing requirements mandate that a company meet specified minimum thresholds for the number of publicly traded shares, total market value, stock price, and number of shareholders. After a company starts trading, it must continue to meet different standards set by the exchanges or the Nasdaq Stock Market. Otherwise, the company can be delisted. These continuing standards usually are less stringent than the initial listing requirements.

**Long-term debt** – Debt with a maturity of more than one year from the current date.

**Loss** – Excess of expenditures over revenue for a period or activity. Also, for tax purposes, an excess of basis over the amount realized in a transaction.

**Lower of cost or market** – Valuing assets for financial reporting purposes. Ordinarily, “cost” is the purchase price of the asset and “market” refers to its current replacement cost. Generally accepted accounting principles (GAAP) requires that certain assets (e.g., inventories) be carried at the lower of cost or market.

**Management discussion and analysis (MD&A)** – SEC requirement in financial reporting for an explanation by management of significant changes in operations, assets, and liquidity.

**Manipulation** – Manipulation is intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security. Manipulation can involve a number of techniques to affect the supply of, or demand for, a stock. They include spreading false or misleading information about a company; improperly limiting the number of publicly-available

shares; or rigging quotes, prices, or trades to create a false or deceptive picture of the demand for a security.

**Marketable securities** – Stocks and other negotiable instruments which can be easily bought and sold on either listed exchanges or over-the-counter markets.

**Mark-to-market** – Method of valuing assets that results in adjustment of an asset's carrying amount to its market value.

**Matching principle** – The concept that all costs and expenses incurred in generating revenues must be recognized in the same reporting period as the related revenues.

**Materiality** – Magnitude of an omission or misstatements of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would change or be influenced.

**Mergers** – Mergers are business transactions involving the combination of two or more companies into a single entity. Most state laws require that mergers be approved by at least a majority of the company's shareholders if the merger will have a significant impact on the company.

**Modified cash basis** – A special purpose framework that begins with the cash basis method (see **Cash basis**) and applies modifications having substantial support, such as recording depreciation on fixed assets or accruing income taxes.

**Nasdaq** – Nasdaq stands for the National Association of Securities Dealers Automated Quotation System. Unlike the New York Stock Exchange where trades take place on an exchange, Nasdaq is an electronic stock market that uses a computerized system to provide brokers and dealers with price quotes. The National Association of Securities Dealers, Inc. owns and operates The Nasdaq Stock Market.

**Net assets** – Excess of the value of securities owned, cash, receivables, and other assets over the liabilities of the company.

**Net income** – Excess or deficit of total revenues and gains compared with total expenses and losses for an accounting period.

**Net sales** – Sales at gross invoice amounts less any adjustments for returns, allowances, or discounts taken.

**Net worth** – Similar to equity, the excess of assets over liabilities.

**Nonpublic entity** – Any entity other than (a) one whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally; (b) one that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market; or (c) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b).

**No-par stock** – Stock authorized to be issued but for which no par value is set in the articles of incorporation. A stated value is set by the board of directors on the issuance of this type of stock.

**No-par value** – Stock or bond that does not have a specific value indicated.

**Notional** – Value assigned to assets or liabilities that is not based on cost or market (e.g., the value of a service not yet rendered).

**Objectivity** – Emphasizing or expressing the nature of reality as it is apart from personal reflection or feelings; independence of mind.

**Paid in capital** – Portion of the stockholders' equity which was paid in by the stockholders, as opposed to capital arising from profitable operations.

**Par value** – Amount per share set in the articles of incorporation of a corporation to be entered in the capital stocks account where it is left permanently and signifies a cushion of equity capital for the protection of creditors.

**Parent company** – Company that has a controlling interest in the common stock of another.

**Predecessor accountant** – An accountant who (a) has reported on the most recent compiled or reviewed financial statements or was engaged to perform but did not complete a compilation or review of the financial statements, and (b) has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

**Preferred stock** – Type of capital stock that carries certain preferences over common stock, such as a prior claim on dividends and assets.

**Premium** – (1) Excess amount paid for a bond over its face amount. (2) In insurance, the cost of specified coverage for a designated period of time.

**Prepaid expense** – Cost incurred to acquire economically useful goods or services that are expected to be consumed in the revenue-earning process within the operating cycle.

**Prescribed form** – Any standard preprinted form designed or adopted by the body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form.

**Present value** – Current value of a given future cash flow stream, discounted at a given rate.

**Principal** – Face amount of a security, exclusive of any premium or interest. The basis for interest computations.

**Proxy statement** – The SEC requires that shareholders of a company whose securities are registered under Section 12 of the Securities Exchange Act of 1934 receive a proxy statement prior to a shareholder meeting, whether an annual or special meeting. The information contained in the statement must be filed with the SEC before soliciting a shareholder vote on the election of directors and the approval of other corporate action. Solicitations, whether by

management or shareholders, must disclose all important facts about the issues on which shareholders are asked to vote.

**Purchase method of accounting** – Accounting for a merger by adding the acquired company's assets at the price paid for them to the acquiring company's assets.

**Quiet period** – The term "quiet period," also referred to as the "waiting period," is not defined under the federal securities laws. The quiet period extends from the time a company files a registration statement with the SEC until SEC staff declares the registration statement "effective." During this period, the federal securities laws limit what information a company and related parties can release to the public. Rule 134 of the Securities Act of 1933 discusses these limitations.

**Ratio analysis** – Comparison of actual or projected data for a particular company to other data for that company or industry in order to analyze trends or relationships.

**Real property** – Land and improvements, including buildings and personal property that is permanently attached to the land or customarily transferred with the land.

**Receivables** – Amounts of money due from customers or other debtors.

**Reconciliation** – Comparison of two numbers to demonstrate the basis for the difference between them.

**Registration under the securities act of 1933** – Often referred to as the "truth in securities" law, the Securities Act of 1933 has two basic objectives: (1) To require that investors receive financial and other significant information concerning securities being offered for public sale; and (2) To prohibit deceit, misrepresentations, and other fraud in the sale of securities. The SEC accomplishes these goals primarily by requiring that companies disclose important financial information through the registration of securities. This information enables investors, not the government, to make informed judgments about whether to purchase a company's securities.

**Regulation D offerings** – Under the Securities Act of 1933, any offer to sell securities must either be registered with the SEC or meet an exemption. Regulation D (or Reg D) provides three exemptions from the registration requirements, allowing some smaller companies to offer and sell their securities without having to register the securities with the SEC.

**Regulatory basis** – A special purpose framework that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.

**Reissued report** – A report issued subsequent to the date of the original report that bears the same date as the original report. A reissued report may need to be revised for the effects of specific events; in these circumstances, the report should be dual-dated with the original date and a separate date that applies to the effects of such events.

**Related party transaction** – Business or other transaction between persons who do not have an arm's-length relationship (e.g., a relationship with independent, competing interests). The

most common is between family members or controlled entities. For tax purposes, these types of transactions are generally subject to a greater level of scrutiny.

**Research and development (R&D)** – Research is a planned activity aimed at discovery of new knowledge with the hope of developing new or improved products and services. Development is the translation of research findings into a plan or design of new or improved products and services.

**Retained earnings** – Accumulated undistributed earnings of a company retained for future needs or for future distribution to its owners.

**Revenue recognition** – Method of determining whether or not income has met the conditions of being earned and realized or is realizable.

**Revenues** – Sales of products, merchandise, and services; and earnings from interest, dividend, rents.

**Review** – Accounting service that provides some assurance as to the reliability of financial information. In a review, a certified public accountant (CPA) does not conduct an examination under generally accepted auditing standards (GAAS). Instead, the accountant performs inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with GAAP or, if applicable, with a special purpose framework.

**Risk management** – Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.

**Security** – Any kind of transferable certificate of ownership including equity securities and debt securities.

**Short-term** – Current; ordinarily due within one year.

**SSARS** – Statements on Standards for Accounting And Review Services issued by the AICPA Accounting and Review Services Committee (ARSC).

**Start-up costs** – (1) Costs, excluding acquisition costs, incurred to bring a new unit into production. (2) Costs incurred to begin a business.

**Statement of cash flows** – A statement of cash flows is one of the basic financial statements that is required as part of a complete set of financial statements prepared in conformity with generally accepted accounting principles. It categorizes net cash provided or used during a period as operating, investing and financing activities, and reconciles beginning and ending cash and cash equivalents.

**Statement of financial condition** – Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation as of a specified date, the entity's assets, liabilities, and the equity of its owners. Also known as *balance sheet*.

**Statutory basis** – See Regulatory basis.

**Straight-line depreciation** – Accounting method that reflects an equal amount of wear and tear during each period of an asset's useful life. For instance, the annual straight-line depreciation of a \$10,000 asset expected to last ten years is \$1,000.

**Strike price** – Price of a financial instrument at which conversion or exercise occurs.

**Submission of financial statements** – Presenting to a client or third party's financial statements that the accountant has prepared either manually or through the use of computer software.

**Subsequent event** – Material event that occurs after the end of the accounting period and before the publication of an entity's financial statements. Such events are disclosed in the notes to the financial statements.

**Successor accountant** – An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement or an accountant who has accepted such an engagement.

**Tangible asset** – Assets having a physical existence, such as cash, land, buildings, machinery, or claims on property, investments or goods in process.

**Tax** – Charge levied by a governmental unit on income, consumption, wealth, or other basis.

**Third party** – All parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

**Trade date** – Date when a security transaction is entered into, to be settled on at a later date. Transactions involving financial instruments are generally accounted for on the trade date.

**Treasury bill** – Short-term obligation that bears no interest and is sold at a discount.

**Treasury bond** – Long-term obligation that matures more than five years from issuance and bears interest.

**Treasury note** – Intermediate-term obligation that matures one to five years from issuance and bears interest.

**Treasury stock** – Stock reacquired by the issuing company. It may be held indefinitely, retired, issued upon exercise of stock options, or resold.

**Trial balance** – A trial balance consists of a listing of all of the general ledger accounts and their corresponding debit or credit balances. Also, in a trial balance, no attempt is made to establish a mathematical relationship among the assets, liabilities, equity, revenues, and expenses except that total debits equal total credits.

**Unearned income** – Payments received for services which have not yet been performed.

**Updated report** – A report issued by a continuing accountant that takes into consideration information that he/she becomes aware of during his/her current engagement and that re-



expresses his/her previous conclusions or, depending on the circumstances, expresses different conclusions on the financial statements of a prior period as of the date of his/her current report.

**Valuation allowance** – Method of lowering or raising an object's current value by adjusting its acquisition cost to reflect its market value by use of a contra account.

**Variance** – Deviation or difference between an estimated value and the actual value.

**Work in progress** – Inventory account consisting of partially completed goods awaiting completion and transfer to finished inventory.

**Working capital** – Excess of current assets over current liabilities.

**Working papers** – (1) Records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the course of the audit. (2) Any records developed by a certified public accountant (CPA) during an audit.

**Yield** – Return on an investment an investor receives from dividends or interest expressed as a percentage of the cost of the security.



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# **AUDIT WORKPAPERS: DOCUMENTING AND REVIEWING FIELD WORK**

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**BY DON PALLAIS, CPA**

Solutions

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# Solutions

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## Chapter 1

### Knowledge check solutions

1.
    - a. Incorrect. Audit documentation is required on every audit.
    - b. Correct. There are some items required to be in every audit's working papers, such as audit programs and documentation of internal control, and working papers are required to indicate, for example, who prepared them.
    - c. Incorrect. Statements on Standards for Accounting and Review Services (SSARS) require documentation on every compilation engagement.
    - d. Incorrect. As long as the required matters are documented, the manner of documentation is a matter of professional judgment
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## Chapter 2

### Knowledge check solutions

1.
    - a. Incorrect. There is no requirement for audit programs to state conclusions.
    - b. Incorrect. Professional standards do not require explicit conclusions to be documented for each substantive test.
    - c. Correct. Conclusions should be readily determinable from the work done, but need not be explicit.
    - d. Incorrect. Audit tests generally provide a basis for such a conclusion only on the financial statements taken as a whole, not for individual items.
  2.
    - a. Incorrect. If additional information, such as the subsequent discovery of facts existing at the balance sheet date, comes to the auditor's attention, they should be dealt with and the working papers updated noting that new information has been added.
    - b. Correct. No information may be deleted from the working papers after that date.
    - c. Incorrect. In some cases new information, such as previously unknown facts or realization that an important auditing procedure was inadvertently omitted, comes to the auditor's attention *after the date of the auditor's report* indicating the need for additional audit procedures or causing the auditor to draw new conclusions. In those situations the auditor should add documentation to the audit file indicating the additional work done.
    - d. Incorrect. All files should be retained in accordance with your firm's file retention policy.
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3.
    - a. Incorrect. Questions are generally raised as a result of incomplete working papers or incomplete audit work, whether electronic or not would not affect the completeness of the working papers.
    - b. Incorrect. A hidden danger in the use of automated working papers is the risk that working papers can be changed with relatively little record of the change.
    - c. Incorrect. A properly completed electronic working paper is acceptable documentation.
    - d. Correct. The purpose of automating working papers is to increase efficiency.
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## Chapter 3

### Knowledge check solutions

1.
  - a. Correct. Primary detail schedules are analyses of individual general ledger accounts.
  - b. Incorrect. A trial balance is merely a listing of general ledger accounts.
  - c. Incorrect. A grouping schedule shows how individual accounts in the trial balance are combined in the financial statements. It does not provide analysis.
  - d. Incorrect. A check copy represents evidence obtained; it does not analyze an account.
2.
  - a. Incorrect. The primary detail schedules are the basis for account testing.
  - b. Correct. Lead schedules summarize similar or related accounts that will be combined into a single line item in the financial statements.
  - c. Incorrect. The testing to be applied is described in the audit program or audit plan.
  - d. Incorrect. The schedule does not provide the evidence. Cross references to audit evidence may exist on the lead schedule.
3.
  - a. Incorrect. While some auditors segregate the entries made from those waived, all should be summarized.
  - b. Correct. The auditor is required to aggregate all entries proposed to see if, individually or in combination, they are material to the financial statements.
  - c. Incorrect. The auditor is required to aggregate those entries proposed but waived to see if the uncorrected amounts individually or in combination, are material to the financial statements.
  - d. Incorrect. Supporting analysis is generally provided by the working paper documenting the test; it is not duplicated on the summary of adjusting entries. The summary generally provides a reference to the working paper on which the analysis is done.



## Chapter 4

### Suggested solution to case study 4-1:

ABC Company allowance for doubtful accounts—W/P C11 12/31/X2				
	20X2		20X1	
Balance beginning of year	143,000	L	123,000	L
Provision for uncollectibles	31,000	TB	80,000	L
Less: write-offs during the year	(20,000)	C12	(60,000)	L
Balance end of year	154,000	TB	143,000	L
Accounts receivable (gross) 12/31	2,563,000	C1	2,424,000	L
Less: allowance (above)	(154,000)		(143,000)	
Net accounts receivable	2,409,000		2,281,000	
Sales for year	15,563,000	TB	14,625,000	L
A/R as a percent of sales	15.48%	P	15.60%	L
Allowance for uncollectibles as a percent of A/R	6.01%	P	5.90%	L
Provision for uncollectibles as a percent of sales	0.199%	X	0.547%	L
L      Agreed to 12/31/X1 working papers. P      Consistent with prior year and expectations. X      According to the VP of Credit, the provision for uncollectibles was proportionately less than for 20X1 because [explanation]. To corroborate this explanation [describe tests to corroborate the explanation and an indication that the auditor considers it reasonable or a proposed entry to adjust the balance.]				

### Observations:

The working paper is in the form of a comparative analysis schedule. Summarizing the activity for the year allows for easy identification of the components of the year's activity—the provision and the write-offs.

This analysis makes it apparent that, although the current year allowance is higher than the prior year, there were substantially lower write-offs, suggesting that it might be understated.

All of the prior year balances and analyses are agreed to the prior year working papers and the current year amounts are agreed to the trial balance or other working paper analyses.

Although the balance is consistent with the prior year, the working paper identifies a potential anomaly in that the provision and write-offs are much lower in relation to sales than in the previous year. This comparison prompts an inquiry regarding the unexpected fluctuation. The explanation provided by the client is documented and is either consistent with other information, such as any detailed work (for example, analysis of the aging of accounts receivable) reflected in other working papers or generates a proposed adjustment.

The comparison with the prior year provides context, but it might be more effective to develop a more robust history such as a five-year analysis to better determine trends and identify outliers.

### Knowledge check solutions

1.

- a. Correct. However, the form and extent of the documentation may vary.
- b. Incorrect. The requirement to document the auditor's understanding applies to all audits, regardless of whether or not the controls are effective.
- c. Incorrect. The requirement to document the auditor's understanding applies to all audits, regardless of whether or not the controls will be tested for effectiveness.
- d. Incorrect. It is required on all audits, regardless of the financial reporting framework used.

2.

- a. Incorrect. The auditor should document the nature, timing, and extent of the tests, the linkage of those procedures with the assessed risks at the relevant assertion level, and the results of those procedures.
- b. Incorrect. The auditor should document the nature, timing, and extent of the tests, the linkage of those procedures with the assessed risks at the relevant assertion level, and the results of those procedures.
- c. Incorrect. The auditor should document the nature, timing, and extent of the tests, the linkage of those procedures with the assessed risks at the relevant assertion level, and the results of those procedures.
- d. Correct. An auditor who has not requested confirmations in testing accounts receivable is required to document how he or she overcame the presumption that the auditor will confirm accounts receivable unless either accounts receivable are immaterial, the use of confirmations would be ineffective, or the auditor's combined assessed level of inherent and control risk is low and the evidence expected to be provided by substantive procedures is sufficient to reduce audit risk to an acceptably low level.

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## Chapter 5

### Knowledge check solutions

1.
  - a. Incorrect. There are no specific ratios the auditor must consider under GAAS.
  - b. Correct. It is hard to defend working papers in a lawsuit when, after the fact, the reason for an unusual relationship documented in the working papers becomes clear, but the auditor did not consider the relationship significant at the time.
  - c. Incorrect. While it is possible for the wrong formulas to be applied, this danger is not unique to computerized working papers, and it is generally less likely than for manually-prepared working papers.
  - d. Incorrect. Calculations done electronically are generally more efficient than those done manually.
2.
  - a. Incorrect. This is acceptable and is the policy in many firms, but it is not required.
  - b. Incorrect. This is a common method for reviewing work and supervising and training staff.
  - c. Incorrect. This is acceptable, but it is not required.
  - d. Correct. The additional work should appear on the working papers themselves and all items noted in the review should be followed up appropriately and cleared by the reviewer but there is no GAAS requirement regarding retention of review notes.

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## Chapter 6

### Knowledge check solutions

1.
  - a. Incorrect. Providing complete copies of working papers, including the evidence obtained and judgments made, might compromise the effectiveness of the audit.
  - b. Incorrect. If the auditor wants working papers in that format, providing copies to use as a guide is an efficient approach.
  - c. Correct. This can be an efficient approach as long as the audit procedures actually applied have been deleted.
  - d. Incorrect. Mere preparation of a schedule does not constitute audit testing and is not limited to any category of client personnel.

2.

- a. Incorrect. The auditor should avoid unnecessary procedures. If only the totals are meaningful and can be tested by a single independent computation, the auditor should just check the total and avoid unnecessary proving of subtotals.
- b. Correct. Not all computations and subtotals on client-prepared schedules need to be proven. If only the totals are meaningful and can be tested by a single independent computation, the auditor should just check the total and avoid unnecessary proving of details.
- c. Incorrect. The auditor should avoid unnecessary procedures. As in a, above, the auditor should avoid unnecessary proving of subtotals regardless of the provenance of the working paper.
- d. Incorrect. Agreement with accounting records does not by itself demonstrate arithmetic accuracy.

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## Chapter 7

### Knowledge check solutions

1.

- a. Incorrect. Audit documentation is required on every audit.
- b. Correct. There are some items required to be in every audit's working papers, such as audit programs and documentation of internal control and working papers are required to indicate, for example, who prepared them.
- c. Incorrect. Working papers are important for various reasons, including documenting conformity with auditing standards for supervisory review, practice monitoring (for example, peer review), and for litigation, if necessary.
- d. Incorrect. Working papers are required to describe the scope of procedures applied.

2.

- a. Incorrect. The AICPA establishes GAAS requirements, but they provide only general guidance about working paper contents.
- b. Incorrect. Working papers are a tool for auditors, not clients.
- c. Correct. The auditor decides on the level of detail appropriate in the circumstances.
- d. Incorrect. Peer reviews are not done until long after audits are completed.

- 3.
- a. Incorrect. The partner's review is not generally detailed, but focused on higher-level issues (although in smaller audits a partner might conduct a detailed review).
  - b. Correct. The in-charge accountant's review of the working papers should be comprehensive, including reports and the management letter.
  - c. Incorrect. Staff accountants generally do not perform a formal review. However, staff accountants should perform an informal review of their own work before having it reviewed by others.
  - d. Incorrect. The partner's review is not generally detailed, but focused on higher-level issues (although in smaller audits a partner might conduct a detailed review). Staff accountants generally do not perform a formal review. However, staff accountants should perform an informal review of their own work before having it reviewed by others.
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## Chapter 8

### Knowledge check solutions

- 1.
- a. Incorrect. While notes from the in-charge review may be retained or discarded, separate to-do lists are not generally included in the completed working paper file.
  - b. Incorrect. While completing all to-dos is a valuable goal, it is often impractical as the auditor may be awaiting information to be provided by the client.
  - c. Incorrect. The standards are silent on the disposition of the reviewer's notes, but they are generally maintained with the files until the partner has signed off on the engagement, and then discarded or retained according to firm policy. Separate to-do lists are not generally included in the completed working paper file.
  - d. Correct. The incomplete items should be listed to make the partner aware and to control their ultimate completion.
- 2.
- a. Incorrect. Seeing that the audit plan has been signed off does not provide the in-charge that the prescribed procedure has been properly applied.
  - b. Correct. The in-charge should make sure the test called for has been applied as designed.
  - c. Incorrect. The partner's review does not typically involve a detailed comparison of the audit plan to the work done.
  - d. Incorrect. The reviewer should consider whether the staff auditor has satisfactorily completed the steps relevant to the staff auditor's work.

3.

- a. Incorrect. Auditing standards do not require staff auditors to review their own work.
- b. Correct. It is a good idea that the staff review the working papers first to make sure they are complete and ready for review.
- c. Incorrect. The time spent by the staff can save the reviewer time and provides training for the working paper preparers.
- d. Incorrect. Nothing in GAAS prohibits this; it is generally a good idea.

4.

- a. Correct. Start a working paper review just as the audit was started. Start at the beginning by understanding the client's business and current circumstances.
- b. Incorrect. The prior year review notes, which might not have been retained, relate only to the work done by the staff auditor during that year's audit. Although they might be interesting, they typically have no continuing significance for the current year.
- c. Incorrect. Later in the review, you will ensure that the detailed checklists have been completed.
- d. Incorrect. The detailed review is generally done before the final financial statements are drafted.

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## Chapter 9

### Case study solutions

#### *Internal control flowchart:*

The flowchart by itself would not meet the requirements of AU-C section 315. Other items that would have to be documented include the following, for example:

- How the data gets posted to the general ledger.
- Information about computer processing (software, access, and so on).
- Controls over cash (for example, bank reconciliations).

The flowchart shows that "Betty" performs conflicting duties (she is involved in preparing coding sheets and preparing manually written checks, matches all of the prepared checks [both manually and computer prepared] with invoices before the checks are signed and gets the signed checks back for mailing) and yet there is no comment about it on the working paper or any cross-reference to another working paper dealing with that point. The effect of the conflicting duties on the auditor's assessment of the level of control risk should be documented and the item should be put on a summary listing of potential internal control weaknesses that must be communicated to those charged with governance.

*Cash:*

Page A-1:

Five checks were written and cleared the general bank account at amounts different from the ones that were recorded in the books; although the amount of the differences was not material and the reason for the largest difference was investigated, there is nothing to indicate that anyone was concerned about the frequency of the errors; the fact that the last sentence of tick mark "y" implies that such errors occur regularly; their cause could be a breakdown in internal control, carelessness, someone frequently not doing their job, and so on; and whether or not something could and should be done to correct the situation. Also, there is no indication as to what position Janet holds and whether the situation was brought to the attention of appropriate client officials.

The auditor may waive trivial adjustments without aggregating them for later analysis, however, the judgment of what constitutes "trivial" should be made for the audit overall, it should not be made unilaterally by the staff auditor (although it's not clear this was a unilateral decision).

Page A-2:

The payroll account working paper states that the account bears interest, but the bank confirmation does not agree with that and there is no indication that this difference has been satisfactorily resolved.

While it is apparent that tick mark "C" means the balance was confirmed, it is preferable to note that on the working paper. The confusion is compounded by the use of another tick mark "C" that means something else. Different letters should be used to avoid misinterpretation.

The reasonableness test described at tick mark "D" could be improved, if the amount were significant. Instead of merely comparing the balance to the previous year a better approach might be to estimate cash float – for example, average of \$150,000 for a five-day period, 24 times a year, at an interest rate of 5 percent yields an increase in interest of \$2,500 for the year.

Page B-2/4:

*Patient accounts receivable aging carryforward:*

The September 30, 20X9, aging percentages do not cross-foot to 100 percent.

The date of the update work for 20X7-20X9 is not shown.

Page B-6:

*Allowance for doubtful student accounts:*

The source of, and basis for, the 5.25 percent rate used in the "computation of allowance" is not stated. Also, if the percentage is one that has been used for several years and it is resulting in computed amounts that are consistently higher than the amount that is deemed reasonable, consideration should be given to revising it.

The tick mark "✓" is unexplained.

The opening balances were not agreed to the prior year working papers.

It is not shown here, but for this to be a useful procedure, the auditor should be satisfied that the data analyzed here come from a reliable source (for example, an aging summary whose categorizations have been tested). Unless the amount is considered trivial, the adjustments should be posted to the summary of proposed audit adjustments rather than being waived on the working paper.

Page B-7:

*Farm contracts receivable:*

Payments of principal and interest were made in April 20X9 but there is no indication as to the status of, and any work done in regard to, accrued interest receivable for the five months of May through September 20X9.

There is no indication that the balances were confirmed, any explanation as to why they were not confirmed if that is the case, or any work done to support the balances.

Page BB-2:

*Accounts payable – unprocessed invoices:*

The working paper indicates that these unpaid invoices are all held by the accounting department. There is nothing to indicate that any inquiry or other work was done to ascertain whether there were any unpaid invoices being held by another department (for example, pharmacy, dietary, housekeeping, and so on).

There is no indication of why the larger older invoices (for example, February 10, 20X9, June 15, 20X9, July 29, 20X9, August 18, 20X9) are still being held or that anyone inquired about it.

Page B-7:

*Blue Cross insurance expense:*

There is no title on the working paper.

There is no indication of which client records the payments made by employees (\$176,510.41) were agreed to or what work was done on this amount.

The \$2,588 unreconciled difference should be reported to the summary of proposed audit adjustments, not merely waived on the working paper.

The \* comment does not explain what caused the large decrease in expense or even indicate that the auditor did any work to satisfy himself as to its reasonableness. For example, the \* comment might have gone on to say something like "...primarily due to a large decrease in claims experienced this year. Also, the Hospital switched in FY20X9 to a \$100 deductible for each employee entering as an inpatient and this resulted in an estimated \$25,000 reduction in FY20X9 expense."



Page CC-2:

*State income tax withheld:*

The working paper states that there were three pay dates included in the accrual balance at both September 30, 20X9, and September 30, 20X8, and shows that the September 30, 20X9, balance is almost \$9,400 more than the September 30, 20X8, balance but does not explain why the accrual increased 26 percent even though the number of pay periods included is the same. Also, there is no indication that the auditor did any work to test the reasonableness of such an increase. If, for example, an investigation revealed that the increase resulted from an increase in the State income tax rates in 20X9 and such an explanation, along with a rough computation in support of it, should be added to the working paper.

Page SI-1&2:

*Self-insurance fund summary:*

The source and basis for the \* comment about minimum balance and the conclusion are not stated; for example, it might have read, "per review of actuarial report, which was obtained directly from the actuary and is in the Permanent File, the minimum balance..."

Self-Insurance Fund – Fund Balance – There is no indication that the amount "paid to the Hospital for legal fees" was traced to the applicable Hospital account.

There is no basis for the conclusion that an 11.2 percent interest rate is reasonable.

The cross-reference to working paper SI-1/11 (account 153-01) seems odd, given that this is working paper SI-1.

## Knowledge check solutions

1.

- a. Incorrect. It is unnecessary to document the check for mathematical accuracy, as schedules prepared by the auditor are presumed to have been checked.
- b. Correct. Schedules prepared by the client need to be checked for mathematical accuracy.
- c. Incorrect. The client's assurance as to accuracy does not absolve the auditor from checking it (except when the auditor previously tested accuracy as an internal control.)
- d. Incorrect. The auditor needs to check mathematical accuracy of relevant information only.

2.

- a. Incorrect. There is nothing wrong with using a shortened name.
- b. Correct. The working paper should indicate who did the work and when it was done.
- c. Incorrect. Although the working papers should indicate who reviewed the work, the standards do not require the reviewer to sign off each individual working paper. Many firms, however, do require this and many auditors consider it to be best practice.
- d. Incorrect. While many auditors state the objective on each working paper, it is not a uniform practice. (If the firm's policy to do so, however, failure to state the objective would be a shortcoming.)

3.

- a. Correct. Working papers prepared by the client should be so noted.
- b. Incorrect. The working papers are required to document the date the audit work was done, not the date the client drafted the schedule.
- c. Incorrect. Working papers prepared by the client need not be copied over.
- d. Incorrect. Working papers may be manual or electronic.

4.

- a. Incorrect. Although it might be useful, auditing standards do not require documentation of the basis for the expectation (however, when used as the principal substantive test of a significant financial statement assertion, the auditor is required to document the factors considered in developing the expectation).
- b. Correct. The auditor needs to obtain and document the explanation for the variance.
- c. Incorrect. The choice of tests applied each year depends on events and circumstances particular to that year without regard to what was done in earlier periods.
- d. Incorrect. When analytical procedures involve comparison to the prior year, this should be documented, but many analytical procedures do not involve such comparisons. It need not be documented if it is not integral to the procedure.

5.

- a. Correct. The auditor should accumulate both those corrected and not corrected by the client, although the analysis should indicate which were corrected and which were not corrected.
- b. Incorrect. The auditor may designate a very small amount below which adjustments need not be posted to the summary of audit adjustments.
- c. Incorrect. The auditor should indicate which have not been corrected and include them in the representation letter and communications with those charged with governance.
- d. Incorrect. The auditor has to summarize adjustments proposed but not corrected in order to determine whether they result in a material misstatement.

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