How To Use These Notes

These study notes are strategically broken down into the most important topics related to Audit Planning on the Auditing and Attestation (AUD) section of the CPA Exam.

There are 3 popular ways people use these notes:

1. Read a section before watching your CPA review videos to get an understanding of the topic

2. Review a section periodically as a refresher to keep the material fresh

3. Review / rewrite all the notes in the 2 weeks leading up to your exam date to ensure the material is fresh in your mind

If you would like more helpful review materials, check out www.pedersoncpareview.com for MP3 audio notes, flashcards, videos and live, one-on-one help from me.

If you find these notes valuable, please consider buying the full set of AUD Study Notes or signing up for my review course at Pederson CPA Review.

Best of luck with the exam.

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Overall

An audit consists of 7 major steps:

1. Audit planning
2. Understanding internal control
3. Assessing the risk of material misstatement
4. Testing controls
5. Substantive testing
6. Wrap up
7. Issuing the audit report

The flow of transactions to the financial statements is:

[Diagram showing the flow of transactions from Source Documents to Financial Statements with controls at each stage]

Auditors must trace transactions through all 4 stages. Auditors gather evidence through source documents and ensure the related transactions are appropriately accumulated in the subsidiary ledgers. Then, they trace information from the subsidiary ledgers to the general ledger. Finally, they ensure the financial statements reflect what is in the general ledger.

Auditors also test the controls that exist between each stage of the transaction flow.

In this way, auditors gather evidence at the individual transaction level and ensure the correct amounts ultimately are reported in the financials.

Much of what an auditor has to do involves determining the best way to collect and evaluate that evidence.

An auditor is like a detective. When solving a crime, there are certain steps a detective must take in all investigations, but each crime has its own unique circumstances that require the detective to rely on knowledge and experience in determining the best tools to
use in solving the crime.

Similarly, there are certain standard audit tests and procedures, but often, the auditor has to rely on the knowledge of how transactions should flow and what evidence might be available when determining what audit procedures to follow.

Due to time and cost constraints, auditors cannot test every transaction. As a result, this introduces risk the auditor will miss a material misstatement. To minimize this risk, auditors put in place requirements on how samples will be chosen and evaluated.

**Audit Planning**

Audits should be planned to obtain reasonable assurance the financial statements are free of material misstatement. To do this, the audit plan should consider the financial statement assertions and should limit audit risk to an acceptable level.

**Audit Planning** – Includes deciding whether to accept an engagement, the engagement letter, assessing risk, developing an audit strategy and developing the audit plan.

- Establish an understanding with management that the auditor is responsible for communicating any significant deficiencies to the audit committee
- Coordinating data needed with the client
- Establishing the inventory observation date
- Discussing the client with other CPA firm personnel familiar with the client
- Reading current year financials
- Compare current year financials to estimates

**GAAS Audit Documentation** – Includes:

- A written audit plan with procedures needed to achieve objectives
- Acknowledgment that accounting records reconcile to the financials
Assessment of the risk of material misstatement

No engagement letter is required

**Obtaining An Understanding Of Client** – Requirement on every audit.

Review prior year workpapers and permanent file

Objective is to understand transactions that impact the client

**Predecessor Auditors** – Before accepting a new audit client, the auditor must get the client’s permission to contact the predecessor auditor.

Ask the predecessor auditor about disagreements with management and why the client decided to change auditors.

Review predecessor auditor workpapers for balance sheet accounts and contingencies

If misstatements are discovered, ask client to arrange a meeting with the client and predecessor auditor to resolve.

Cannot review engagement letter

**Engagement Letter** – Include objectives, CPA responsibilities, management responsibilities and the limits of the engagement.

State that it is management’s responsibility for internal control

Include fees

State that the CPA may find opportunities to improvement operations

State that there is a risk that material misstatements or fraud will not be found

List other services being performed

**Understanding With Client** – Document in writing.

Often this is in the form of an engagement letter, but it does not have to be.
Initial Planning – Discuss timing of audit with management.

Management Disregard Of Internal Control – Causes auditors to refuse the engagement.

Attestation Standards – Include:

- The auditor needs sufficient evidence to form a reasonable basis for conclusion
- The report must identify the subject matter
- The report must state the character of the engagement
- The work must be adequately planned and supervised

PCAOB 3 – Critical review is required at every level of supervision.

Known as the due care requirement.

2nd Partner Review – Used to determine whether the financials are in conformity with GAAP and whether enough audit evidence exists to support the opinion.

Financial Statement Assertions – Can apply to account balances, classes of transactions and disclosures.

Account Balance Assertions – Include:

- Completeness
- Existence or occurrence
- Rights and obligations
- Valuation and allocation
- Presentation and disclosure

Existence Or Occurrence – Address whether assets or liabilities exist at a given date and whether transactions occurred during a given period.
Testing for existence or occurrence is mainly done for assets, revenues, and gains.

**Completeness** – Address whether all transactions and accounts are appropriately included in the financial statements.

Testing for completeness is mainly done for liabilities, expenses, and losses.

**Rights And Obligations** – Address whether the entity has the legal right to assets and whether liabilities are a legal obligation of the entity.

**Valuation And Allocation** – Address whether transactions are included in the financial statements at appropriate amounts.

**Presentation And Disclosure** – Address whether transactions are properly classified, described and disclosed in the financial statements.

**Relevant Assertion** – Financial statement assertion that has a reasonable possibility of causing a material misstatement.

**Materiality** – The concept that some items are important to the users of financial statements and some items are not.

- Based on financial results
- Involves both quantitative and qualitative factors
- Based on what a reasonable person would need in order to rely on the financials
- Not based on control risk
- If materiality decreases, test closer to year-end
- If there are 2 different levels of materiality (1 for the balance sheet and 1 for the income statement), use the lower amount

**Assessing Risk** – Inherent risk, control risk, and detection risk may be assessed quantitatively or qualitatively.

**Audit Risk** – The risk an auditor expresses an incorrect opinion.
Audit risk is a function of the risk of misstatement and detection risk

**Audit Risk Formula** = Risk of Material Misstatement x Detection Risk

**Risk Of Material Misstatement Formula** = Inherent Risk x Control Risk

**Material Misstatement** – Material errors, material fraud, and certain illegal acts.

**Inherent Risk** – Likelihood of material misstatement assuming there is no internal control.

**Control Risk** – Likelihood that a material misstatement will not be prevented or detected by internal control.

**Inherent Risk And Control Risk** – Exist independent of the audit.

They result from the client and the environment and cannot be affected by audit tests

**Detection Risk** – Risk that an auditor incorrectly concludes a material error does not exist.

Risk that testing fails to detect multiple misstatements

Allowable risk of material misstatement

Low level of acceptable detection risk may require testing closer to year-end

When the acceptable level of detection risk decreases, substantive testing increases

**Control Risk And Detection Risk** – If control risk increases, the auditor should decrease the acceptable level of detection risk.

**Improper Revenue Recognition** – Presumed to be a risk on all audits.

**Professional Skepticism** – The requirement that an auditor has a questioning mind and makes a critical assessment of the audit evidence.

The auditor should make no assumptions about management honesty or dishonesty
**Risk Assessment** – Analytical procedures, inspection of documents, observation of employees performing tasks.

- Analytical procedures should focus on enhancing the understanding of the client
- Used to identify unusual transactions and events
- Identify risks
- Anticipate what may go wrong
- Evaluate significance
- Consider the likelihood an item will lead to material misstatement
- Risks often involve judgments and estimates

**Substantive Tests** – Further testing after the risk assessment.

**Adequate Financial Records** – Needed for every audit.

**Valuations** – Items requiring valuation require advance planning due to the use of a specialist.

**Inventory Observation** – Requires coordination between the auditor and client to ensure all parties can attend.

**Knowledge Of Accounting And Auditing Standards** – Required for the auditor who has final responsibility for the audit.

**Supervisor Auditor** – Should explain to staff how evidence should be evaluated.

- Performs review to ensure staff work was adequate and the results of testing were consistent with the conclusion in the audit report
- If staff disagrees with the supervisor auditor, document the disagreement along with the conclusion reached
Audit Program – Should be designed so that procedures will achieve audit objectives.

  Finalized after consideration of internal control

  Should ensure audit evidence supports the audit conclusion

  Audit objectives should relate to financial statement assertions

Audit Procedures – Can be performed at interim dates.

  If control risk is high or the acceptable level of detection risk is low, testing should not be performed at interim dates

Attestation – Does not involve historical financials.

GAAS – Does apply to historical financials.

Accounting Trends And Techniques – Book that shows how other companies report and disclose various transactions.

Examination Of Financial Forecast – Evaluate the forecast and the underlying assumptions.

  Requires independence