

TOP AUDITING ISSUES FOR 2011 CPE COURSE

Perry M. Henderson, CPA, MPA

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Contributors

Technical Review.....	James L. Ulvog, CPA
Production Coordinator	Susan Haldiman
Production	Lynn J. Brown
Layout & Design.....	Laila Gaidulis

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4025 W. Peterson Ave.
Chicago, IL 60646-6085
1 800 344 3734
www.CCHGroup.com

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Introduction

The year 2011 will see implementation of four significant new auditing standards. This course presents guidance that will assist auditors in assimilating these new standards and incorporating them into practice.

Statement on Auditing Standards No. 117, *Compliance Audits* (SAS 117) was developed in response to a 2007 study by the President's Council on Integrity and Efficiency (the PCIE Study) of the quality of audits conducted under Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. It significantly expands the requirements for compliance audits.

Three additional new standards relate to other information in documents containing audited financial statements, supplementary information, and required supplementary information:

- Statement on Auditing Standards No. 118, *Other Information in Documents Containing Audited Financial Statements* (SAS 118).
- Statement on Auditing Standards No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (SAS 119).
- Statement on Auditing Standards No. 120, *Required Supplementary Information* (SAS 120).

Throughout 2010 and 2011 the AICPA is continuing the redrafting of its existing standards under its Clarity Project. This project aims to redraft all of the existing auditing standards into a new, uniform format that clearly distinguishes requirements from explanatory material and application guidance. Once the redrafting is finished, the standards will be codified into a single authoritative source. All of the redrafted and clarified standards will become effective at once. Presently, this is expected to be for periods ending on or after December 15, 2012—calendar year 2012 audits. It is important to note that early implementation is not permitted.

This course is structured in two Modules. The first Module covers four newly-released auditing standards. Each brings significant change to current auditing practice. The content of Module 1 is:

- Chapter 1: SAS 117, *Compliance Audits*.
- Chapter 2: SAS 118, *Other Information in Documents Containing Audited Financial Statements*.
- Chapter 3: SAS 119, *Supplementary Information in Relation to the Financial Statements as a Whole*.
- Chapter 4: SAS 120, *Required Supplementary Information*.

Module 2 covers redrafted and clarified versions of several of the Risk Assessment Standards under the AICPA's Clarity Project. These standards reorganize, and in some cases streamline the previously existing standards. They do not bring major changes to auditing practice. They do, however, demonstrate the AICPA's intent to move toward a more principles-based body of standards, and away from strictly rule-based standards.

The content of Module 2 is:

- Chapter 5: SAS 106, *Audit Evidence* (Redrafted) and SAS 107, *Evaluation of Misstatements Identified During the Audit*.
- Chapter 6: SAS 108, *Planning an Audit* and SAS 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating Audit Evidence Obtained* (Redrafted).
- Chapter 7: SAS 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Redrafted).

Throughout this course you will find comments that are vital to understanding a particular strategy or idea, Illustrations and Observations to clarify the material covered, and Study Questions to help test your knowledge. Answers to the Study Questions, with feedback on both correct and incorrect responses, are provided in a special section beginning on page 113.

To assist you in your later reference and research, a detailed topical index has been included for this course beginning on page 147.

As noted above, this course is divided into two Modules. Take your time and review both course Modules. When you feel confident that you thoroughly understand the material, turn to the CPE Quizzer. Complete one or both Module Quizzers for Continuing Professional Education credit. You can complete and return the Quizzers to CCH for grading at an additional charge. If you receive a grade of 70 percent or higher on the Quizzers, you will receive CPE credit. Further information is provided in the CPE Quizzer instructions on page 155.

September 2010

Perry M. Henderson, CPA, MPA

COURSE OBJECTIVES

This course was prepared to provide coverage of the recently published auditing standards on compliance auditing, as well as discussion of the three new standards related to other information in documents containing audited financial statements, supplementary information, and required supplementary information. It also covers four of the recently redrafted standards under the AICPA's Clarity Project. Upon completion of this course, the reader will be able to:

- Define key terminology used in Statement on Auditing Standards No. 117, *Compliance Audits* (SAS 117).
- Determine when SAS 117 is applicable to an engagement.
- List management's responsibilities in a compliance audit and distinguish them from the auditor's responsibilities.
- Explain the professional requirements of SAS 117 and apply them in practice.
- Describe and explain the auditor's responsibilities with respect of other information in documents containing audited financial statements.
- Define the terms "inconsistency" and "misstatement of fact" and distinguish between the two in practical audit situations.
- Determine proper responses to inconsistencies and misstatements of fact identified in other information that accompanies audited financial statements.
- Explain the auditor's responsibilities with respect to supplementary information in relation to the financial statements as a whole.
- List the additional procedures that are to be applied to supplementary information.
- Report properly on supplementary information using the new standard report wording.
- Recognize practical situations in which modifications to the standard report wording are required.
- Identify required supplementary information and distinguish it from other types of information that may accompany financial statements.
- List the professional requirements related to required supplementary information.
- Explain the auditor's reporting requirements and objectives for required supplementary information.
- Identify the characteristics of sufficient and appropriate audit evidence.
- Determine the reliability and relevance of audit evidence.
- Explain the process of evaluating misstatements identified during an audit.
- Determine the effects of identified misstatements on the conduct of an audit.
- Explain the requirements for planning an audit.
- Recognize and appropriately respond to identified risks in practical auditing situations.
- Explain the evaluation process for audit evidence obtained.

- Explain how to obtain an understanding of the entity and its environment, in order to provide a basis for responding to assessed risks of material misstatement.
- Identify and assess the risk of material misstatement at the financial statement and relevant assertion level.

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ABOUT THE AUTHOR

Perry M. Henderson has over thirty years of experience in public accounting. For over twenty years, he has been a sole practitioner providing audit and accounting services to nonprofit organizations and privately held businesses. He has performed peer reviews of about five hundred accounting firms and has served on the Peer Review Committee and Professional Conduct Committee of the California Society of CPAs. He is the author of the *CPA's Guide to Quality Control and Peer Reviews*, and of *Top Auditing Issues* since 2006. He also has contributed material to several other CCH publications and to various publications of the AICPA and the California Society of CPAs.

Mr. Henderson holds a bachelor's degree from Claremont McKenna College and a master's degree in public administration from the University of Oklahoma. He has been as an adjunct faculty member at the University of Redlands and has served on the Executive Committee of the AICPA's Government Audit Quality Center.

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MODULE 1: NEW SASs — CHAPTER 1

SAS 117, Compliance Audits

LEARNING OBJECTIVES

Upon completion of this chapter, the reader will be able to:

- Define key terminology used in Statement on Auditing Standards No. 117, *Compliance Audits* (SAS 117).
- Determine when SAS 117 is applicable to an engagement.
- List management's responsibilities in a compliance audit and distinguish them from the auditor's responsibilities.
- Explain the professional requirements of SAS 117 and apply them in practice.

INTRODUCTION

The Auditing Standards Board (ASB) issued Statement on Auditing Standards No. 117, *Compliance Audits* (SAS 117) in December 2009. It supersedes SAS 74, (AU Section 801) *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*.

SAS 117 was developed in response to a 2007 study by the President's Council on Integrity and Efficiency (the PCIE Study) of the quality of audits conducted under Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. This study showed that improvements to the compliance auditing process were needed in many areas.

SAS 117 establishes standards and provides guidance on performing and reporting on an audit of an entity's compliance with applicable governmental audit compliance requirements. This includes audits under:

- OMB Circular A-133, also referred to as single audits.
- Department of Housing and Urban Development (HUD) *Consolidated Audit Guide for Audits of HUD Programs*.

SAS 117 updates SAS 74 in several significant respects. The most important of those are that it:

- Incorporates the Risk Assessment Standards, SASs 104 through 111.
- Requires auditors to adapt and apply generally accepted auditing standards (GAAS), including the fraud and risk assessment standards, to a compliance audit.

- Identifies sections from GAAS, (the AU Sections) that are applicable to compliance audits and those that are not.
- Defines terms related to compliance audits.
- Identifies requirements that are unique to a compliance audit.
- Identifies elements to be included in an auditor's report on a compliance audit.
- Reflects changes in the compliance auditing environment.
- Provides guidance for evaluating whether an entity has materially complied with applicable compliance requirements.
- Clarifies the applicability of the standard.

SAS 117 is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.

SIGNIFICANT CHANGES TO EXISTING STANDARDS AND PRACTICE

The impact of SAS 117 on a firm's compliance auditing practice is likely to depend on how closely the firm has been following the AICPA Audit Guide *Government Auditing Standards and OMB Circular A-133 Audits* (the *GAS/A-133 Guide*) and adapting the existing SASs to its compliance audits. The PCIE study identified half of the audits in its nationwide statistical sample as being unacceptable or of limited reliability. The ASB expects that SAS 117 will result in significant improvements to, and changes in such engagements.

SAS 117 brings the following significant changes to compliance auditing:

- Expanded applicability of SAS 117, to include not only audits under OMB Circular A-133 but those under certain federal agency audit guides, such as the HUD *Consolidated Audit Guide*.
- Expanded discussion of management's responsibilities for compliance.
- A more detailed description of auditor requirements than SAS 74.
- Increased guidance related to applying auditor requirements.
- Inclusion of certain compliance auditing considerations as professional requirements that had previously been non-authoritative guidance under the *GAS/A-133 Guide*.
- Clarification of the applicability of other AU Sections to compliance audits. SAS 117 states that all AU sections are applicable to compliance audits except those specifically exempted in Appendix A of SAS 117. The most significant of these is SAS 99, *Consideration of Fraud in a Financial Statement Audit*.

STUDY QUESTION

1. The ASB expects that SAS 117 will result in significant changes to the compliance auditing practice of firms that have not been closely following the AICPA Audit Guide *Government Auditing Standards and OMB Circular A-133 Audits* (the *GAS/A-133 Guide*) and adapting the existing SASs to their compliance audits. **True or False?**

APPLICABILITY

SAS 117 is applicable when an auditor is engaged, or is required by law or regulation, to perform a compliance audit in accordance with *all three* of the following:

- Generally accepted auditing standards (GAAS).
- The standards for financial audits under *Government Auditing Standards* (GAS), also referred to as the “Yellow Book.”
- A governmental audit that requires the expression of an opinion on compliance.

SAS 117 does not apply to:

- The financial statement component of a compliance audit that is performed in conjunction with a financial statement audit.
- Engagements in which governmental audit requirements call for an examination under the *Statements on Standards for Attestation Engagements* of:
 - An entity’s compliance with specified requirements, or
 - Internal control over compliance.

OBSERVATION

Common examples of engagements to which SAS 117 applies are audits performed under OMB Circular A-133, or HUD’s Audit Requirements Related to Entities Such As Public Housing Agencies, Nonprofit and For-Profit Housing Projects, and Certain Lenders. Both of these engagements are conducted under GAAS and the Yellow Book, and require the auditor to express an opinion on compliance.

Examples of engagements to which SAS 117 does not apply include an examination of an entity’s compliance with specified requirements of the U.S. Department of Education’s audit guide, *Audits of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers* under AT section 601, *Compliance Attestation*. Another case in which SAS 117 does not apply is an engagement performed to satisfy a law or regulation requiring an entity to have an auditor determine whether transportation excise taxes have been spent in accordance with specific

purposes described in law or regulation, but not requiring an audit under both GAAS and the Yellow Book. Such an engagement could be performed under AT section 101, *Attest Engagements*, AT section 201, *Agreed-Upon Procedures Engagements*, or AT section 601.

STUDY QUESTION

2. SAS 117 is applicable when an auditor is engaged, or is required by law or regulation, to perform a compliance audit in accordance with three specific criteria. Which of the following is one of those criteria?
 - a. The financial statement component of a compliance audit that is performed in conjunction with a financial statement audit.
 - b. Engagements in which governmental audit requirements call for an examination under the *Statements on Standards for Attestation Engagements* of an entity's compliance with specified requirements.
 - c. Engagements in which governmental audit requirements call for an examination under the *Statements on Standards for Attestation Engagements* of an entity's internal control over compliance.
 - d. Engagements in which an auditor is engaged, or is required by law or regulation, to perform a compliance audit in accordance with the standards for financial audits under *Government Auditing Standards*.

MANAGEMENT'S RESPONSIBILITIES

SAS 117 states that compliance audits are based on the premise that compliance with an entity's compliance requirements is a management responsibility. It expands SAS 74's discussion of those responsibilities to include:

- Identifying the entity's government programs.
- Understanding those programs.
- Complying with the compliance requirements of the government programs.
- Establishing and maintaining effective controls to provide reasonable assurance that government programs are administered in compliance with the compliance requirements.
- Evaluating and monitoring compliance with compliance requirements.
- Taking corrective action on instances of noncompliance, including the audit findings of a compliance audit.

OBSERVATION

This discussion adds emphasis on management's responsibilities in several areas that were not mentioned in SAS 74: management's understanding of its government programs, evaluation and monitoring compliance, and corrective actions. This emphasis is consistent with one of the ASB's general philosophical directions in the post-Enron environment, which is to draw a more sharply defined distinction between management's responsibilities and those of the auditor. In the case of SAS 117, this emphasis counteracts possible erroneous perceptions by either management or the public that the auditor is responsible, for example, for identifying government programs or for monitoring compliance.

STUDY QUESTION

3. In defining management's responsibilities in a compliance audit, and distinguishing them from the auditor's responsibilities, SAS 117 states that:
 - a. The auditor is responsible for identifying government programs.
 - b. Management is responsible for understanding its government programs.
 - c. The auditor is responsible for monitoring compliance.
 - d. Management is responsible for defining the compliance requirements that are applicable to its government programs.

OBJECTIVES OF SAS 117

SAS 117 sets forth two objectives:

- To obtain sufficient appropriate audit evidence to enable the auditor to express an opinion on whether the entity has complied with applicable compliance requirements. This requirement includes reporting at the level specified in the governmental audit requirements. In most cases, this is at the program level, although some governmental audit requirements may specify a different level, such as the applicable compliance requirement level.
- To identify additional audit and reporting requirements imposed by the governmental audit requirements that go beyond GAAS and *Government Auditing Standards*, and to perform procedures that address those requirements.

DEFINITIONS

SAS 117 defines twenty-one terms that are applicable to compliance audits. These definitions group into several conceptual areas. The most significant of those groupings and definitions are discussed below.

Audit Risk in a Compliance Audit

SAS 117 presents three terms that adapt the definitions of risk assessment in the Risk Assessment Standards for financial statement audits to the compliance auditing environment. These terms are comparable to those used for financial statement audits.

- Audit risk of noncompliance.
- Detection risk of noncompliance.
- Risk of material noncompliance.

Audit risk in a financial statement audit is focused on material misstatement of the financial statements. In a compliance audit, this focus shifts to noncompliance. Audit risk of noncompliance (AR) is a function of the risk of material noncompliance (RMN) and detection risk of noncompliance (DR).

SAS 117 defines *audit risk of noncompliance* as the risk that an auditor will express an inappropriate opinion on compliance, when material noncompliance exists.

Detection risk of noncompliance is the risk that auditing procedures will not detect an instance of noncompliance that could be material, either by itself or in combination with other instances of noncompliance.

Risk of material noncompliance contains two components, similar to its counterpart, risk of material misstatement, in SAS 107, *Audit Risk and Materiality in Conducting an Audit* (AU Section 312). Those are inherent risk of noncompliance, and control risk of noncompliance. It defines *inherent risk of noncompliance* (IR) as the susceptibility of a compliance requirement that could be material, either by itself or in combination with other instances of noncompliance, before consideration of any controls over compliance. *Control risk of noncompliance* (CR) is the risk that material noncompliance could occur and not be prevented or detected and corrected on a timely basis by the entity's internal control over compliance.

Audit risk of noncompliance can thus be expressed as the following formula:

$$AR = DR \times IR \times CR$$

OBSERVATION

The concepts of inherent and control risk are common to both compliance and financial statement audits. One useful way to think of these concepts is to think of dynamite. Dynamite is a dangerous substance. The chemical properties that make it dangerous are the same no matter where it is or who has it. This is dynamite's inherent risk. Control risk is concerned with who has the dynamite, where they have it and what they are doing with it. In the hands of the hazardous materials unit of a fire department, the control risk over the dynamite would be considered low. In the hands of a terrorist, the control risk would be extremely high.

Deficiencies in Internal Control Over Compliance

SAS 117 conforms the definitions and classifications of deficiencies in internal control over compliance to those of SAS 115, *Communicating Internal Control Related Matters Identified in an Audit* (AU Section 325), for financial statement audits. *Deficiencies in internal control over compliance* may be of two types:

- *Design deficiencies*, in which a control necessary to meet the compliance objective is either missing or is not properly designed so as to meet the control objective, or
- *Operating deficiencies*, in which a properly designed control either does not operate as designed or the person performing the control does not have the authority or the competence to perform it effectively.

A *deficiency in internal control over compliance* exists when the design or operation of that control does not allow management or employees, in the ordinary course of performing their assigned functions, to prevent or to timely detect and correct noncompliance.

A *material weakness in internal control over compliance* is a deficiency or a combination of deficiencies such that there is a reasonable possibility that material noncompliance will not be prevented or timely detected and corrected. SAS 117 defines a *reasonable possibility* using the following constructs:

- Remote. The chance of a future occurrence is slight.
- Probable. A future occurrence is likely.
- Reasonably possible. The chance of a future occurrence is more than remote but less than likely.

A *significant deficiency in internal control over compliance* is a deficiency or combination of deficiencies that is less severe than a material weakness, but still important enough to warrant attention by those charged with governance.

Material Noncompliance

In the absence of a more specific definition in particular governmental audit requirements, *material noncompliance* is a failure to follow compliance requirements or a violation of prohibitions in an applicable compliance requirement that results in noncompliance that is quantitatively or qualitatively material to the affected government program, either individually or when aggregated with other noncompliance.

Questioned Costs

Questioned costs are those questioned by the auditor because:

- Of a violation or possible violation of applicable compliance requirements,
- Of a lack of adequate documentary support, or
- They appear unreasonable and do not reflect actions that a prudent person would take in the circumstances.

Known questioned costs are those specifically identified by the auditor, and are a subset of likely questioned costs. *Likely questioned costs* are defined as the auditor's best estimate of total questioned costs, including known questioned costs. This estimate is developed by extrapolation from audit evidence obtained, such as by projecting sample results to an entire population.

Compliance Audit

Compliance audits may be either organization-wide or program-specific.

An *organization-wide audit* encompasses both an audit of the entity's financial statements and an audit of its compliance with the applicable compliance requirements of one or more government programs that the entity administers.

A *program-specific audit* is an audit of the entity's compliance with applicable compliance requirements as they relate to one government program that the entity administers. The compliance portion of a program-specific audit is performed in conjunction with an audit of either the entity's or the program's financial statements.

Governmental Audit Requirement

A governmental audit requirement is a requirement established by law, regulation, rule, or by the provisions of contracts or grant agreements. These requirements may also set forth specific supplementary requirements, such as procedures to be performed by the auditor, documentation requirements, the form of reporting, or continuing education requirements for the auditor.

OBSERVATION

An important source of information about compliance requirements for Federal programs is the *Compliance Supplement* to OMB Circular A-133. This document is updated annually. Programs may be added or deleted, and requirements on any program may change from year to year. It is therefore important to check this document for each year that a compliance audit is to be performed. It is available at the OMB's Web site, **www.whitehouse.gov/omb/circulars**. Not all Federal programs are listed in the *Compliance Supplement*. This does not, however, mean that the program has no compliance requirements. When a program is not so listed, auditors should read the guidance of Part 7 of the *Compliance Supplement*, to determine applicable compliance requirements. Auditors should also read the award document to determine if there are supplementary requirements. This is particularly critical when Federal awards are passed through to an entity from an intermediate recipient such as a State. That "pass-through entity" may also impose its own compliance requirements in addition to the Federal requirements. There also may be a program-specific audit guide issued by the grantor agency.