

2013

KNOWLEDGE-BASED AUDITS™ OF COMMERCIAL ENTITIES

DENISE M. SILVA
ROBERT K. PEARSON

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Knowledge-Based Audits™ of Commercial Entities

Denise M. Silva

Robert K. Pearson



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This volume, along with its associated materials, provides references to material important for an accounting firm in conducting an audit of non-public entities. This volume is not intended, and cannot, substitute for reading the actual standards and other official guidance discussed herein, nor for updates or additions to accounting and auditing rules, regulations and practices from the appropriate regulatory agencies that are relevant to the conduct of an audit.

Practice continues to evolve on many of the issues that are addressed in this reference work. The positions set forth herein represent our understanding of current practice. Given the changing conditions and the complexity of certain issues, users should closely monitor the viewpoints expressed and consult with experts on specific matters, as appropriate. We will continue to update this publication as the need arises.

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Knowledge-Based Audits™ of Commercial Entities

By Denise M. Silva and Robert K. Pearson

Highlights

CCH's *Knowledge-Based Audits™ of Commercial Entities* provides practitioners with an effective approach for conducting audits of commercial entities. This guide features an in-depth discussion of CCH's Knowledge-Based Audit™ (KBA) methodology, a risk-based methodology that is fully compliant with the Auditing Standards Board's (ASB) clarified auditing standards. The KBA methodology drives audit strategy that is scalable to any size engagement, participating in any industry, while aiding the auditor in achieving efficiencies and effectiveness resulting in overall cost-saving by helping to reduce the tendency to overaudit. In addition to the discussion of CCH's Knowledge-Based Audit™ (KBA) methodology, this guide also provides practical examples, as well as a complete set of Knowledge-Based Audit™ workpapers⁽²⁾ that complement this guide. These workpapers include practice aids, audit programs, checklists, questionnaires, workpapers, sample correspondence, and sample auditor's reports—that take the practitioner through an engagement from the initial evaluation of a client to the issuance of the auditor's reports on the financial statements. Additionally, the workpapers included with this guide, also provide the audit procedures, checklists, sample correspondence needed, if the auditor determines it is necessary to test the operating effectiveness of entity's internal controls over financial reporting. These tools are available through CCH's Accounting Research Manager.

2013 Edition

This edition of the *Knowledge-Based Audits™ of Commercial Entities* provides guidance on the implementation of the standards and rules promulgated by the ASB, as well as includes best practices based on the guidance promulgated by the Public Company Accounting Oversight Board (PCAOB) and other regulators. This guide has been updated to include guidance on the ASB's Statement on Auditing Standards (SAS) No. 126, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, as well as accounting requirements of the Financial Accounting Standards Board (FASB), current through Accounting Standards Update (ASU) No. 2011-12, *Comprehensive Income (Topic 220)*. In addition, the audit guide has been completely restructured to flow better with the execution of an audit. Other updates include the following:

- Chapter 1, *AICPA: The Clarified Standards, Convergence, Current Activities, Attestation, Quality Control, and Ethical Standards*: New chapter incorporates in one place a discussion of all of the standards that should be considered when conducting an audit of a commercial entity. The application of these standards is integrated throughout the rest of the guide.
- Chapter 21, *Fair Value Measurements*: New chapter includes a comprehensive discussion of the accounting and auditing of fair value measurements.

Throughout the text, Practice Points have been included that highlight the significant issues and audit findings observed during peer review inspections activities. With the incorporation of the ASB clarity standards, CCH's Knowledge-Based Audits,[™] provides the best practice information available; enabling accountants to prepare for and auditors to conduct high quality audits of financial statements.

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The Audit library covers auditing standards, attestation engagement standards, accounting and review services standards, audit risk alerts, and other vital auditing-related guidance. You'll also have online access to our best-selling *GAAS Practice Manual*, *Knowledge-Based Audits™ of Commercial Entities*, *Knowledge-Based Compilations and Reviews*, *Attestation Guide*, *CPA's Guide to Effective Engagement Letters*, and *CPA's Guide to Management Letter Comments* and be kept up-to-date on the latest authoritative literature via the *GAAS Update Service*.

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Our Peer Review Policy

Thank you for ordering the 2013 *Knowledge-Based Audits™ of Commercial Entities*. Each year we bring you the best engagement guides available with accompanying electronic workpapers and practice aids. To confirm the technical accuracy and quality control of our materials, CCH voluntarily submits to a peer review of our publishing system and our publications.

Our publications are reviewed every step of the way—from concept development to production—to ensure that we bring you the finest guides and workpapers on the market. In addition to peer review, our publications are updated annually and undergo strict technical and content reviews by qualified practitioners. This ensures that our books and practice aids are compliant with the most current standards and have “real world” applicability.

Peer Review Letter

**Caldwell, Becker, Dervin, Petrick & Co., L.L.P.**

CERTIFIED PUBLIC ACCOUNTANTS

Quality Control Materials Review Report

November 12, 2009

Executive Board

CCH, a Wolters Kluwer business

and the National Peer Review Committee

We have reviewed the system of quality control for the development and maintenance of Knowledge-Based AuditTM Procedures (2010 Edition) (hereafter referred to as *materials*) of CCH, a Wolters Kluwer business (the organization) and the resultant materials in effect at October 31, 2009. Our quality control materials peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. The organization is responsible for designing a system of quality control and complying with it to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in conforming with those professional standards that the materials purport to encompass. Our responsibility is to express an opinion on the design of the system and the organization's compliance with that system based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a Quality Control Materials Review are described in the standards at www.aicpa.org/prsummary.

In our opinion, the system of quality control for the development and maintenance of the quality control materials of CCH, a Wolters Kluwer business was suitably designed and was being complied with during the year ended October 31, 2009, to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in conforming with those professional standards the materials purport to encompass. Also, in our opinion, the quality control materials referred to above are reliable aids at October 31, 2009. Organizations can receive a rating of *pass*, *pass with deficiency(ies)*, or *fail*. CCH, a Wolters Kluwer business has received a peer review rating of *pass*.

CALDWELL, BECKER, DERVIN, PETRICK & Co., LLP.

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Preface

The primary objective of *Knowledge-Based Audits™ of Commercial Entities*, is to show practitioners the most effective approach for conducting high-quality audits of commercial entities. *Knowledge-Based Audits™ of Commercial Entities*, provides practical discussion and consideration of the day-to-day management of commercial entity audit engagements. The guide reduces the technical language of ASB official pronouncements, rules and regulations to easy-to-read and easy-to-understand advice and procedures. Designed to enhance the quality of your practice, this guide presents an approach that will help you perform your audit engagements effectively and efficiently.

Throughout, *Knowledge-Based Audits™ of Commercial Entities*, includes numerous Knowledge-Based Audit™ documents—practice aids, audit programs, checklists, questionnaires, workpapers, sample correspondence, and sample auditor's reports—that will take you through an engagement from the initial evaluation of a client to the issuance of the auditor's reports on internal controls over financial reporting and the financial statements. This guide can be used for audits of financial statements, and for audits in which the auditor determines it necessary to test the operating effectiveness of internal controls.

Knowledge-Based Audits™ of Commercial Entities, covers all major audit topics, including the following:

- Overview of ASB clarified auditing standards and rules, as well as an overview of the Knowledge-Based Audits™ methodology;
- Financial statement assertions and internal control frameworks;
- Preliminary engagement activities and audit planning;
- Audit strategy and overall audit approach;
- Audit risk and materiality;
- Risk assessment procedures, including obtaining an understanding of the entity and its environment and its internal controls over financial reporting, as well as assessing risk of material misstatement, to include inherent and control risk;
- Fraud risk assessment, including the importance of the team discussion;
- Audit sampling for both the tests of operating effectiveness of internal control and substantive tests of details;
- Analytical procedures: used in planning, used as substantive tests, and as part of evaluating and concluding the audit engagement;
- Potential errors and fraud schemes in specific audit areas and examples of fraud-related audit procedures;
- Evaluation and testing of an entity's internal controls over financial reporting, including required communications;
- All major audit areas: cash; investments and derivatives; accounts receivable; inventory; property, plant, and equipment; other assets; accounts payable;

ble and accrued expenses; debt obligations; income taxes; equity; revenue and expenses; related-party transactions, contingent liabilities; significant estimates; share-based payments, and fair value measurements and disclosures;

- Audit evidence and workpaper documentation requirements;
- Financial accounting and reporting disclosures, including comprehensive disclosure checklists;
- General audit procedures at various stages of the audit; and
- Auditor's reports and other required communications.

List of Abbreviations

The following reference abbreviations are used in this guide:

- AU-C—ASB Auditing Standard (i.e., Codified Clarified Standard)
- ASC—FASB's Accounting Standards Codification™
- QC—The quality control standards series in *AICPA Professional Standards* (Volume 2)
- ET—The Code of Professional Conduct in *AICPA Professional Standards* (Volume 2)
- TIS—The Technical Questions and Answers series in *AICPA Technical Practice Aids* (Volume 1)

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Thanks are due to the staff of CCH and especially to Sandra Lim, senior developmental editor, for her constructive input and diligent efforts in preparing this publication, and to Nancy Chapman, senior manuscript editor, for her hard work in bringing this edition to press.

The authors and publisher also wish to thank James L. Ulvog, CPA, Alta Loma, CA, for his technical review and comments on the 2013 edition of *Knowledge-Based Audits™ of Commercial Entities*.

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CHAPTER 1

AICPA: THE CLARIFIED STANDARDS, CONVERGENCE, CURRENT ACTIVITIES, ATTESTATION, QUALITY CONTROL, AND ETHICAL STANDARDS

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AUDITING STANDARDS ISSUED BY THE AICPA'S AUDITING STANDARDS BOARD

In 2004, in light of the creation of the Public Company Accounting Oversight Board (PCAOB), pursuant to the Sarbanes-Oxley Act of 2002, as well as the move toward globalization of auditing standards, the AICPA's Auditing Standards Board (ASB) undertook the task of making U.S. generally accepted auditing standards (GAAS) easier to read, understand, and apply; and to converge the auditing standards with International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB), while at the same time avoiding or mitigating unnecessary conflict with PCAOB standards.

Although the ASB expects that most of the ISA requirements will also be requirements of U.S. GAAS, the Board recognizes that there will be instances in which U.S. GAAS requirements will be different in order to address issues specific to the United States. Among other improvements, U.S. GAAS now specifies more clearly the objectives of the auditor and the requirements with which the auditor has to comply in conducting an audit in accordance with U.S. GAAS.

In some cases, extant individual AU Sections have been clarified "one for one" into individual clarified standards. In other cases, some AU Sections have been grouped together or separated and clarified into one or more clarified standards. As a result, topics currently associated with certain AU Section numbers may have been retitled and assigned different AU-C Section numbers. The ASB emphasizes that although the purpose of redrafting the auditing standards was for clarity and convergence and not to create additional requirements, auditors will need to make some adjustments to their audit practices and methodologies as a result of the Clarity Project.

The clarified standards, which include Statements on Quality Control Standards (SQCSs) and Statements on Auditing Standards (SASs), have been redrafted using set drafting convention called the Clarity format, which includes:

- **Introduction.** The introduction explains the purpose and scope of the standard.

- *Objective.* The objective defines the context in which the requirements are set.
- *Definitions.* The definitions section, included where relevant, explains specific meanings of unique terms in the standard.
- *Requirements.* The requirements set out what the auditor is required to do in order to achieve the objective of the standard. Requirements are expressed using the words “the auditor should” for presumptively mandatory requirements and “the auditor must” for unconditional (i.e., mandatory) requirements.
- *Application and Other Explanatory Material.* Application and Other Explanatory Material paragraphs are cross-referenced to the requirements of the standard. The paragraphs are considered integral to the standard and auditors are expected to read and understand these paragraphs, in addition to the main requirements of the standard, in order to meet the standard’s objective.
- Where appropriate, the standards also include “special considerations” relevant to audits of smaller entities and audits of governmental entities.

Upon their initial release, the clarified standards will be referred to with an “AU-C” identifier. The AU-C identifier is temporary and is used to avoid confusion with references to existing AU Sections. The AU-C identifier will revert to AU in 2014, by which time the clarified standards will have become effective for all engagements.

The clarified auditing standards are effective for audits of financial statements for periods ending on or after December 15, 2012 (i.e., 2012 calendar-year audits). For audit firms to experience a smooth transition, it is important to inform, educate, and train staff, as well as begin planning 2012 year-end engagements early.

The ASB has organized the clarified standards according to the following categories:

- Substantive Changes
- Primarily Clarifying Changes
- Primarily Formatting Changes
- Standards Not Yet Issued in the Clarify Project

All of the standards listed below will be introduced in this chapter and discussed in more detail throughout the audit guide.

Substantive Changes

AU-C Sections in this category are considered to likely affect an auditing firm’s methodology and engagements because they contain substantive or other changes, having one or both of the following characteristics:

- Change(s) to the audit methodology that may require effort to implement.
- A number of small changes that, although not individually significant, may affect audit engagements.