

2007

KNOWLEDGE-BASED
AUDITS OF
COMMERCIAL ENTITIES

MICHAEL RAMOS
WAYNE KERR

AND

GEORGE GEORGIADES,
TECHNICAL AUTHOR

PRACTICE
AIDS ON
CD-ROM



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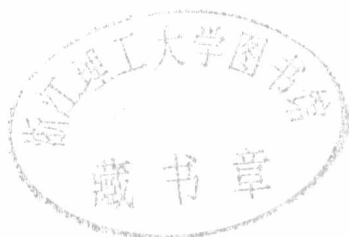
Knowledge-Based Audits of Commercial Entities

Michael Ramos, AuditWatch
Wayne Kerr, AuditWatch
Technical Author: George Georgiades



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ISBN: 978-0-8080-9201-8

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4025 W. Peterson Avenue
Chicago, IL 60646-6085
1 800 248 3248
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Thank you for ordering the 2007 *Knowledge-Based Audits of Commercial Entities*. CCH brings 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 submitted to a peer review of our publishing system and our publications (see the Peer Review Report on the following page).

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Our publications are reviewed every step of the way—from conception to production—to ensure that we bring you the finest guides in the market.

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Peer Review Letter



Caldwell, Becker, Dervin, Petrick & Co., L.L.P.
CERTIFIED PUBLIC ACCOUNTANTS

December 26, 2006

Executive Board
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We have reviewed the system of quality control for the development and maintenance of Knowledge-Based Audits of Commercial Entities, 2007 Edition, of CCH, a Wolters Kluwer business (the company), applicable to non-SEC issuers in effect for the year ended November 30, 2006, and the resultant materials in effect at November 30, 2006. The design of the system, and compliance with it, are the responsibilities of the company. Our responsibility is to express an opinion on the design of the system, and the company's compliance with that system based on our review.

Our review was conducted in accordance with the standards for reviews of quality control materials promulgated by the Peer Review Committee of the Center for Public Company Audit Firms of the American Institute of Certified Public Accountants. In performing our review, we have given consideration to the following general characteristics of a system of quality control. A company's system for the development and maintenance of quality control materials encompasses its organizational structure and the policies and procedures established to provide the users of its materials with reasonable assurance that the quality control materials are reliable aids to assist them in conforming with professional standards in conducting their accounting and auditing practices. The extent of a company's quality control policies and procedures for the development and maintenance of quality control materials and the manner in which they are implemented will depend upon a variety of factors, such as the size and organizational structure of the company and the nature of the materials provided to users. Variance in individual performance and professional interpretation affects the degree of compliance with prescribed quality control policies and procedures. Therefore, adherence to all policies and procedures in every case may not be possible.

Our review and tests were limited to the system of quality control for the development and maintenance of the aforementioned quality control materials of CCH and to the materials themselves and did not extend to the application of these materials by users of the materials nor to the policies and procedures of individual users.

In our opinion, the system of quality control for the development and maintenance of the quality control materials of CCH was suitably designed and was being complied with during the year ended November 30, 2006, to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in conforming with those professional standards in the United States of America applicable to non-SEC issuers. Also, in our opinion, the quality control materials referred to above are reliable aids at November 30, 2006.

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CALDWELL, BECKER, DERVIN, PETRICK & CO., L.L.P.

20750 Ventura Boulevard, Suite 140 • Woodland Hills, CA 91364
(818) 704-1040 • FAX (818) 704-5536

Preface

The eight new risk assessment standards, issued by the Auditing Standards Board, become effective for audits of financial statements beginning on or after December 15, 2006. These new standards make it clear that a checklist-driven audit approach is not acceptable. The new standards place a premium on auditor judgment in the assessment of and response to risk.

This new guidance takes into account a deeper understanding of the client and its internal control environment so auditors can focus on those areas in which the risk of financial statement misstatements is the greatest. Auditors face additional responsibility not only to assure the completeness of disclosures but also to evaluate them in a more qualitative manner. In the new world of auditing, learning about the audit client is not part of planning the audit—it is the audit. The new standards require auditors to address and evaluate materiality more thoroughly; know more about their audit clients; understand their clients' internal controls better than before; conduct a more vigorous risk assessment; as well as document their audit approach and findings.

CCH has teamed with audit experts at AuditWatch, Inc., and Technical Author George Georgiades to provide a Knowledge-Based Audit (KBA) methodology that will assist auditors in complying with and implementing the new standards. The KBA is a methodology that (1) facilitates compliance with GAAS (generally accepted auditing standards), (2) encourages more efficient and effective audits, and (3) helps auditors to identify and focus on risks.

The Knowledge-Based Audit consists of a set of integrated procedures, from pre-engagement all the way through evaluating, concluding, and reporting. The results from each audit stage feed into a Communications Hub, which enables team members to easily view summaries of significant matters, risks, and findings discovered in the audit. This design ensures that important information is not overlooked or hidden in the details of numerous checklists and forms.

This practical guide explains the KBA approach and provides recommended Knowledge Tools on the accompanying back-of-the-book CD-ROM:

- KBA documents, which contain steps and procedures required by GAAS;
- Audit Programs that guide the auditor through related steps and procedures;

- Practice Aids that help the auditor complete steps or processes outlined in other documents;
- Correspondence document templates for engagement letters and confirmation requests; and
- Auditor's Reports document templates for a variety of sample auditor's opinions on audited financial statements.

This first edition of *Knowledge-Based Audits of Commercial Entities* is current through SAS-112.

The authors of *Knowledge-Based Audits of Commercial Entities* welcome comments, suggestions, and recommendations, which will be considered for incorporation in future revisions of the KBA. Please send your comments to:

Debra Rhoades, Senior Managing Editor
CCH, a Wolters Kluwer business
76 Ninth Avenue, 7th Floor
New York, NY 10011
debra.rhoades@wolterskluwer.com

ProSystem fx[®] Knowledge Tools

Complying with the AICPA's new Risk Assessment Standards isn't something you have to do on your own. ProSystemfx Knowledge Tools from CCH provides a streamlined, easy-to-follow audit methodology for implementing these new standards effectively. In addition, new practice aids and tools make the most of technology to support the new audit process and help your firm achieve optimal results. With ProSystemfx Knowledge Tools you can:

- Meet new and expanded documentation requirements by building upon the award-winning industry leader in paperless workflow solutions, ProSystem fx Engagement
- Ensure effectiveness with the Knowledge-Based Audit, an updated audit methodology from a team of experts
- Ensure your entire team has in-depth understanding of your audit client by streamlining the flow of information through the Communications Hub
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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*, *Audit Procedures, Compilations & Reviews*, *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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Acknowledgments

To create these materials we started with a blank sheet of paper, reimagining the audit process to take into account both the spirit of the risk assessment standards and their stated requirements. That reengineering of the audit process required a lot of brainstorming and the thoughtful contributions of several of our dedicated AuditWatch colleagues. We would like to thank Jeff Hodinko, Shawn O'Brien, Suzy Pearse, Brian Kush and Chris Martin for their insight and hard work in creating and reviewing these materials.

The authors and technical author also wish to thank the staff of CCH, especially Mark Hevrdejs, who championed this project from the beginning, and Debra Rhoades for her constructive input and resolute dedication in bringing this edition to press. The authors and publisher also wish to thank Luis Puncel, Director of Accounting and Auditing at Stonefield Josephson, Inc., a California-based CPA firm, and Randy Elder, Director of the Joseph I. Lubin School of Accounting at Syracuse University, for their technical review and comments on the 2007 edition of *Knowledge-Based Audits of Commercial Entities*.

About the Authors

AuditWatch

Michael Ramos

Over the past several years, Michael Ramos has established himself as a provider of practical, high-quality guidance on emerging audit issues. Mr. Ramos was the primary author of the AICPA Audit Guide, "Assessing and Responding to Audit Risk in a Financial Statement Audit," published in December 2006. Other recent books include *How to Implement Sarbanes-Oxley Section 404*, *The SOX 404 Implementation Toolkit*, and *The Auditor's Responsibilities for Detecting Fraud*.

Wayne Kerr

Wayne Kerr is a vice-president at AuditWatch, Inc., specializing in providing quality audit and tailored training for accounting firms throughout North America. Before joining AuditWatch, Mr. Kerr was an audit senior manager with Grant Thornton's Salt Lake City office. At Grant Thornton, he worked with clients in various industries, including manufacturing, not-for-profit, banking, government, and others. He also had quality assurance duties and training responsibilities for his business unit. Mr. Kerr is a member of the American Institute of Certified Public Accountants and the Utah Association of Certified Public Accountants. He graduated from Brigham Young University, receiving both a Bachelor of Science and a Master of Accountancy degree.

Technical Author

George Georgiades, CPA

George Georgiades, CPA, has more than 26 years of experience in public accounting, including seven years as an audit senior manager with a major international firm. He currently has his own firm and consults exclusively with CPA firms on technical accounting, auditing, and financial statement disclosure issues. He has been involved personally in more than 600 audit engagements and related financial statements of both small, closely held companies

and large, publicly held enterprises. He has personally conducted more than 75 peer reviews, consulting reviews, and inspections. Mr. Georgiades is also the author of *GAAP Financial Statement Disclosures Manual*, *GAAS Practice Manual*, and the *GAAS Update Service*. He is a member of the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants, and previously served on the California Society of CPA's Peer Review Committee.

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CHAPTER 1

KNOWLEDGE-BASED AUDIT METHODOLOGY OVERVIEW

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INTRODUCTION

The knowledge-based audit (KBA) methodology is designed to help the auditor efficiently and effectively perform financial statement audits of *nonpublic commercial entities* in accordance with auditing standards generally accepted in the United States of America (GAAS).

Although the KBA approach provides a framework for applying GAAS, it is not a substitute for knowledge of professional standards and the exercise of auditor skepticism and judgment. The auditor may need to refer to additional resources to determine how to apply GAAS to unfamiliar or unique circumstances. In addition to professional literature available through the American Institute of Certified Public Accountants (AICPA), the following resources may be especially useful:

- Accounting Research Manager;
- CCH's *Audit Procedures*;
- CCH's *GAAS Practice Manual*;
- CCH's *GAAS Guide*; and
- CCH's *GAAS Update Service*.

THE KBA METHODOLOGY

The knowledge-based audit is a risk-based audit methodology that emphasizes using knowledge of the entity to make the risk assessments in connection with a financial statement audit. All audits are risk based to some extent because an auditor does not test 100% of the transactions of an entity. The more accurately an auditor assesses an entity's risks of material misstatement, the more

assurance the auditor has that the procedures performed in response to the risk assessments will detect material misstatements. Therefore, the primary drivers of the KBA approach are:

1. Obtaining an understanding of the entity and its environment, including its internal control, sufficient to accurately assess the risks of material misstatement.
2. Designing and performing audit procedures that are responsive to the risks of material misstatement.

For this methodology to be effective, information—or knowledge—must flow through the audit process. The KBA approach is designed to facilitate this flow of information. The forms, practice aids, and audit programs incorporated in this methodology should be customized to the specific circumstances of the entity being audited or the specific nature of the engagement.

This methodology is presented as nine processes, as follows:

1. Pre-Engagement Procedures;
2. Risk Assessment Procedures: Obtaining an Understanding of the Entity and Its Environment;
3. Risk Assessment Procedures: Evaluating the Design of Internal Controls;
4. Assessing the Risks of Material Misstatement;
5. Performing Audit Procedures in Response to Assessed Risks;
6. Performing Audit Procedures: Tests of the Operating Effectiveness of Internal Controls;
7. Performing Audit Procedures: Substantive Tests;
8. Evaluating, Concluding, and Reporting Procedures; and
9. Audit Documentation Requirements.

The understanding obtained in each process affects the decisions made in the next. Although the auditor will likely perform most steps in the methodology sequentially, an audit is not necessarily a linear process. The auditor may need to reconsider decisions made in an earlier process based on evidence obtained in a later stage of the audit.

In general, knowledge of the entity should flow through the preceding nine processes, which affect the audit as follows:

1. Knowledge gained from pre-engagement procedures, the determination of materiality, and preliminary analytical procedures is used to customize the audit plan for risk assessment procedures.

2. Knowledge gained from risk assessment and other procedures is used to identify and assess the risks of material misstatement.
3. Knowledge gained from risk assessment procedures and the risks of material misstatement is used to customize the audit plan for further audit procedures.
4. Evidence gained from further audit procedures is evaluated to determine whether audit risk has been reduced to an acceptably low level, and the appropriate auditor's report is issued.

Audit planning in the KBA methodology is not a single, isolated event but instead involves different processes. For example, the auditor needs to plan (1) pre-engagement procedures, (2) risk assessment procedures, and (3) further audit procedures. The auditor should also plan certain logistical and project management procedures. The auditor may be able to plan a substantial portion of each of these processes in one general audit planning meeting but will more likely need two or more planning sessions to ensure that the knowledge gained in one stage of the audit is adequately addressed in later stages. Judgment should be used in determining how and when to plan the different audit processes. The auditor should also ensure that the planning process takes into account using the knowledge gained from risk assessment procedures in the design of further audit procedures. Keep in mind that evidence gained from performing risk assessment procedures may address relevant assertions and reduce the planned extent of certain further audit procedures.

In applying the KBA methodology, the auditor should:

- Encourage and facilitate communication among audit team members.
- Link the understanding gained in one area to the procedures performed in another.
- Focus on changes from the prior year in determining which information is important when performing risk assessment procedures.
- Customize the audit plan for risk assessment and further audit procedures on each engagement.

The forms and practice aids in the KBA methodology will help the auditor to perform the procedures necessary to complete the audit. The principal document in the KBA is the overall audit program (*AUD-101*). This audit program is designed to guide the auditor through the various processes in the KBA methodology. The auditor should begin each audit with this audit program. Many of the steps

in *AUD-101* reference other forms and practice aids—all of which are considered essential to successfully completing an audit.

The risk assessment forms and practice aids in the KBA methodology are designed to help the auditor gain knowledge of the entity. These documents provide direction for the auditor to gain an understanding of various elements of the entity—often without detailing the specific steps the auditor should perform to achieve that objective. The auditor should use judgment in determining which procedures will best accomplish the objectives of each process given the unique circumstances of the entity or the engagement. Where certain procedures, such as fraud inquiries, are required by GAAS, those procedures are detailed in the forms. In this way, the information-gathering process becomes less mechanical and facilitates the synthesis of information into knowledge of the entity.

Because the knowledge gained in one phase of the audit is critical to decisions in other phases, the KBA methodology has been designed to facilitate the sharing of important information throughout the audit. *AUD-101* and other forms direct the auditor to include certain information in the *Communication Hub*. The *Communication Hub* is a collection of forms that are populated throughout the audit with key information about the entity, including the overall audit strategy, fraud risks and other risks of material misstatement, misstatements identified and other findings, information to be communicated to management, and other items. The *Communication Hub* helps members of the audit team to understand critical information about the entity and ensures that important information is not overlooked or hidden in the details of other forms. The documents in the *Communication Hub* are:

- *KBA-101, Overall Audit Strategy;*
- *KBA-102, Information for Substantive Analytical Procedures;*
- *KBA-103, Significant Matters;*
- *KBA-104, Control Deficiencies and Other Matters;*
- *KBA-105, Summary of Misstatements and Omitted Disclosures.*

The auditor should refer to documents in the *Communication Hub* frequently throughout an audit. For example, the auditor should review these documents (1) prior to beginning a significant audit process such as assessing risk or designing further audit procedures, (2) when beginning a review of audit procedures and documentation, and (3) when evaluating and concluding on audit procedures at the end of the audit. The information in the *Communication Hub* can be especially useful to a high-level or late-stage reviewer, such as a concurring partner, because it summarizes the significant matters, risks, and findings discovered in an audit.