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EXECUTIVE SUMMARY

AUDIT & ACCOUNTING PART 1

Environmental Credits and Obligations 3

In this segment, Jennifer Louis explains the accounting implications of FASB ASU 2026-02, which establishes ASC Topic 818 for environmental credits and environmental credit obligations. The discussion begins with the reasons for the new guidance, including the growing use of environmental credits in regulatory programs, renewable energy mandates, cap-and-trade systems, and voluntary sustainability initiatives. The segment defines environmental credits, describes examples such as emissions allowances, renewable energy certificates, and carbon offsets, and distinguishes voluntary programs from regulatory compliance obligations. It then explains how entities determine whether credits should be recognized as assets or expensed, how credits are classified as compliance or non-compliance, and how classification affects impairment and fair value measurement. The segment also addresses environmental credit obligations, including funded and unfunded portions, financial statement presentation, disclosure requirements, effective dates, early adoption, and transition planning for entities affected by the new standard. *[Running time: 45:24]*

Learning Objectives: Upon completion of this segment, the user should be able to:

- Identify the scope and purpose of FASB ASU 2026-02 and ASC Topic 818 as they relate to environmental credits and environmental credit obligations.
- Distinguish between compliance and non-compliance environmental credits and determine how classification affects recognition, measurement, impairment, and disclosure.
- Apply the recognition and measurement guidance for environmental credit assets and environmental credit obligations, including funded and unfunded portions of regulatory compliance obligations.

AUDIT & ACCOUNTING PART 2

Best Practices for Effective and Efficient Auditing: Performing Tests of Controls and Substantive Tests..... 14

This segment guides auditors through the practical decisions involved in responding to assessed risks. It begins with the relationship among inherent risk, control risk, risk of material misstatement, and detection risk. The instructor then explains how auditors determine whether testing controls will produce enough benefit to justify the effort, including consideration of control design, implementation, available evidence, frequency of operation, and expected substantive-test reductions.

The segment also addresses the design of substantive procedures, including the nature, timing, and extent of testing. It distinguishes required preliminary and final analytical procedures from optional substantive analytical procedures and explains how precision, disaggregation, corroboration, and the reliability of underlying information affect evidential strength. The program concludes with guidance on selecting items for tests of details, defining populations and sampling units, calculating sample sizes, stratifying populations, projecting misstatements, evaluating deviations, and documenting work so an experienced auditor can understand and reperform the procedures. *[Running time: 1:38:42]*

Learning Objectives: Upon completion of this segment, the user should be able to:

- Evaluate whether testing the operating effectiveness of internal controls is an appropriate and cost-effective response to an assessed risk of material misstatement.
- Distinguish among tests of controls, substantive analytical procedures, and substantive tests of details based on their objectives, evidence requirements, and effect on audit risk.
- Design substantive audit procedures whose nature, timing, and extent appropriately respond to relevant assertions and assessed risks.
- Determine appropriate sample sizes for tests of controls and substantive tests of details using population characteristics, desired assurance, tolerable deviation or misstatement, and reliance on other procedures.
- Analyze control deviations and substantive misstatements to determine their effect on control reliance, additional audit procedures, deficiency evaluation, and audit conclusions.
- Document audit procedures, judgments, evidence, and conclusions in a manner that allows an experienced auditor with no prior connection to the engagement to understand and reperform the work.

ABOUT THE SPEAKERS

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AUDIT & ACCOUNTING PART 1

Environmental Credits and Obligations

This video introduces FASB ASU 2026-02, a new accounting standard addressing environmental credits and environmental credit obligations under the newly created ASC Topic 818. The session explains why the guidance was needed, how prior practice relied on analogy to other GAAP, and how the new standard is intended to improve consistency, comparability, and transparency. Viewers will learn how environmental credits are recognized, measured, classified, presented, and disclosed, including the distinction between compliance and non-compliance credits. The video also discusses obligations arising from regulatory compliance programs and key transition considerations for adopting the new guidance.

Ms. Jennifer Louis

Hi, I'm Jennifer Louis, and I want to talk to you today about the new FASB ASU 2026-02 that is related to environmental credits and environmental credit obligations. This is something that was released in May of 2026, and it does create an entirely new topic area of the FASB codification, which is topic area 818.

In looking at this new Topic Section 818, it establishes the guidance related to these types of items, environmental credits and environmental credit obligations, where previous to this there was not anything that specifically related to these topics.

Instead, entities that had these transactions on their books relied on analogy. They might have called items inventory or intangible assets. There also was the use of contingency guidance that looked at the obligations.

The result was that there was significant diversity in practice and how these things were recognized and measured and presented and disclosed. This new topic area 818 creates a consistent framework to help with recognition, measurement, presentation, disclosure, but it also addresses how to transition to this new specific guidance.

As we do have a rapidly growing area of accounting that's driven from a variety of environmental regulations, emission reduction programs, renewable fuel requirements, or renewable energy mandates. But there's also beyond these regulatory things, there's a lot of voluntary sustainability initiatives.

And as we transition to this new guidance, there should be better comparability, but also just more transparency and decision useful information to help users of the financial statements make better decisions based on those financial statements.

The guidance does broadly apply to organizations that may acquire, they may generate or they may receive these credits. They also may transfer or use the credits.

In addition, we have organizations that have an obligation that they're incurring underneath some regulatory programs that may be settled through these environmental credits.

Organizations do need to look at the purpose of these various credits and how they're expected to be used. But in addition, what are the regulatory requirements?

Are these items transferable? And to really think about the disclosures that would be necessary to give the proper qualitative context to these particular types of transactions.

There is a difference in looking at this, where we do have credits that are held for compliance purposes and credits that are held for other purposes. And we'll talk more about that here in just a moment.

But I do want to highlight the fact that we can have a case where I may buy or receive transferable environmental credits, and I may use those credits. And those credits may be used to settle some form of obligation arising from a regulatory compliance program.

I may use those credits to transfer in an exchange type transaction or I may distribute them to an investor in some non-reciprocal transfer. In addition, I may use these credits to meet some sort of voluntary environmental initiative. For example, if I have a carbon neutral or net zero initiative.

When we are looking at these credits, we also may generate them as opposed to buying or receiving them in some other form. When we do look at enforceable reg obligations that might result from a regulatory compliance program, it may be that these obligations might be related to the goal to prevent or reduce or remove emissions or other pollution, and that this enforceable obligation may be settled with these credits.

The goal is to ensure that we are able to keep stakeholders informed about these transactions.

When we do look at the need for this standard, I mentioned how there may be certain regulations and certain standards that we might have to comply with by some form of statute or regulation. There may be renewable fuel standards.

They might be also carbon offset markets. There may be other mechanisms that are increasingly more important to various businesses. There's also what we have is called cap and trade type programs that also may be increasingly out there as far as setting regulations or setting some form of government mandate.

As there may be the need to focus on regulatory compliance programs that exist. So for example, emissions allowances that originate from some cap and trade program that might be either foreign or domestic. There may be renewable identification numbers that originate from the U.S. renewable fuel standard.

When we think about these credits, I think probably more familiar would be these carbon offsets. Carbon offsets are often generated by projects that are intended to reduce or remove your carbon dioxide from the atmosphere.

And these typically are used by entities in those voluntary initiatives. The carbon offset market might allow organizations or even individuals to compensate for my greenhouse gas emissions by purchasing the carbon credits. Each credit represents the fact that I might be removing or avoiding or reducing a ton of CO₂ equivalent.

And what they do is they channel this funding into various environmental projects like reforestation or renewable energy or other similar programs. So, the carbon offset market is really more generally associated with a voluntary initiative.

A cap and trade system is a market-based environmental policy designed to also reduce pollution through a compliance market. But in this case, you might have a government that sets a strict limit or a cap on total emissions.

So, for example, there is a regional greenhouse gas initiative that was formed in cooperation with about 11 different states in the eastern and mid-Atlantic region to cap CO₂ emissions from the power sector.

And companies have to hold permits for every ton of pollution they release. And they can buy or sell these permits on the open market, hence the trade element that is out there.

And what happens is generally when we think about the capped total, it's divided by the individual tradable permits or the allowances, where one permit usually equals the right to emit one ton of some specific pollutant.

Companies are allocated these allowances, or I have to bid on these allowances.

If a company reduces its emissions, It can sell its leftover permits for a profit. If a company pollutes more than the permit allows, I have to buy extra permits from other businesses or face heavy penalties.

So when we look at that element in the cap and trade, it is a government focused initiative versus the voluntary commitment to go net zero or carbon neutral by some given future date. And I can use environmental credits to partially offset my emissions in trying to achieve that goal.

The voluntary carbon markets are decentralized, they're non-regulated market places where I have these self-imposed sustainability goals.

And, but there are platforms where we can basically purchase these credits, such as the United Nations Carbon Offset Platform. So that's a little bit of a background about what these things are.

And as previously mentioned, before the creation of this Topic section 818, the FASB codification did not contain any dedicated guidance addressing these particular transactions.

And so, by analogy, organizations were forced to figure out what other GAAP, what area of GAAP does make the most sense. And in the end, they decided that this merited to have a specific conversation about.

By the way, environmental credits and environmental credit obligations that are in the scope of this new Topic area 818 are not considered in the scope of topic 815 that deals with derivatives and hedging.

The scope of topic 818 does talk about environmental credits, where they're defining that underneath the FASB codification as being enforceable rights represented to prevent, control, reduce, remove emissions or pollution. They are intangible.

They do not have physical substance. They're not a financial asset. And they may be transferable or previously transferable in exchange transactions.

It is not an income tax credit that may be used to settle an entity's income tax liability, regardless of whether the entity has a tax liability or intends to use the credit for that purpose.

We are looking at those things that I already mentioned: emissions allowances or permits in the cap and trade market, renewable identification numbers, renewable energy certificates.

Carbon offsets and similar type things. And as we look at these items, I can have an exchange transaction. I can receive credits through a grant from a regulator or a designee as a part of a regulatory compliance program. I can have internally generated credits, or I can receive environmental credits in a non-specific transfer that is not a grant from a regulator or one of its designees.

The existence of having an active market is not a requirement when determining whether an item that may be an environmental credit is separately transferable when we talk about this exchange transaction.

Part of the definition said that they must be transferable or previously transferable in an exchange transaction. It does not rely on an active market. In addition, the length of time that an item is transferable should not be considered either.

In some cases, we may have an item that may only be separably transferable momentarily because an entity is retiring an item immediately after obtaining it or instructing another party to do so. That item would be subject to the provisions of this topic, assuming that all of the criteria that are contained in this environmental credit definition are met.

It will apply in cases as we think about the environmental credits and also the environmental credit obligations that arise from statutes, laws, ordinance, regulations requiring compliance through environmental credits.

A compliance environmental credit is one as we think about a credit, and it's recognized as an asset if it is probable of being used to settle an environmental credit obligation.

Because remember an environmental credit obligation is something by statute regulation ordinance, like it is a compliance issue. And so when we do look at environmental credit obligations, it does have to involve a regulatory compliance obligation that may be settled using these environmental credits.

If I don't have if I have an environmental credit that does not meet the definition of being a compliance environmental credit, then by default it becomes a non-compliance environmental credit. And this is all important because it will have the classification of the credit does matter.

When we think about the recognition of a credit, when do I recognize an asset?

It is based on a probability recognition model, meaning that it is probable that these credits will be used to settle a regulatory obligation transferred in an exchange transaction or used in some non-reciprocal transfer.

I have something where it is probable that there's future economic value. The assessment of probability is a collective type assessment.

And it's made based on the probability of any of those previous events that I said of occurring. The fact that I might use it to settle an obligation, transfer it in an exchange transaction, or it might be used in a non-reciprocal type transfer.

So, let's give an example. let's say that an entity purchases an environmental credit that it will use to either settle an obligation or transfer in an exchange transaction. The entity determines that there's a 50% likelihood that the credit will be used in one of those two ways. And therefore, I'm going to have an asset that would be recognized because collectively the likelihood of outcomes occurring is probable.

There's a 50% chance that it will be used to settle an obligation and a 50% chance that it will be used to be transferred in an exchange transaction. So in these cases, because it's 50% that one of those two things will occur, then it's probable that there's future value in that credit.

I do not need to have recognized an environmental credit obligation liability to determine that it's probable that I would have a credit that will eventually settle an obligation because the obligation might be recognized in a future period.

But there's factors that they've given to consider how to determine about the probability about this credit being used in one of the three acceptable ways. Settle an obligation, transfer in an exchange transaction, or use in a non-reciprocal transfer.

As we think about the reason why the entity acquired the environmental credit, the quantity of credits that the entity owns compared with its existing and expected obligations.

But also, the entity's past use of environmental credits and whether or not the entity would be committed to transfer an exchange transaction if there were a case where there were things in excess of those needed to satisfy a credit obligation.

This will also be affected by events and activities that might change an organization's need for compliance credits in the future, including thinking about just environmental reduction initiatives overall.

When you're looking at applying recognition requirements, I'm not required to apply this at the individual environmental credit level.

I'll give an example. An entity acquires one thousand renewable energy certificates. It evaluates whether it's probable that the certificates will be used to settle an environmental credit obligation, transfer an exchange transaction, or be used in a non-reciprocal transfer. They do determine that it's probable that we'll use 900 of the thousand certificates.

And that it is also not probable that I will use the remaining hundred certificates. As I have a thousand, I think it's probable I'll use 900. The entity would then recognize 900 of those certificates as environmental credit assets. The remaining hundred renewable energy certificates would be expensed as incurred.

So, I would expense versus capitalize.

And when I do look at these items, when I am focused on certain cases that I am going to be looking at in some environmental credit situations that I would recognize costs related to some environmental credits as an expense when incurred.

For example, environmental credits acquired to satisfy a voluntary net zero emission initiative. It is required that I continually reassess the intended use and the recognition criteria for these credits throughout the life of these credits.

To be clear, a voluntary sustainability commitment does not create environmental credit obligations under Topic 818. Okay, and so where I have credits that are acquired solely for voluntary environmental initiatives, they generally are not going to qualify for asset recognition.

Instead, those are the credits where the related costs are going to be expensed as incurred. So, it does matter on whether it's voluntary or compliance in how we're handling expense versus an asset. Right? But we are looking at cases where if it is related to a case where we are looking at the probability.

So, when they are looking at using it to settle a regulatory obligation is different than settling a voluntary obligation. But I'm also still going to assess whether or not they're going to be transferred in an exchange transaction or used in some non-reciprocal type situation. Those also could be a factor even as it relates to these voluntary credits.

Initial measurement, if I were to have an asset, then depending on how the credits were obtained, there may be different approaches. As I might have internally generated credits or credits that were granted by regulators, they would be measured at whatever transaction costs may have been incurred.

If there were no transaction costs that exist, the initial carrying amount of my credits may be zero. Now, transaction costs can include costs that are necessary to validate or register or authenticate a credit so that it can be used to settle an environmental credit obligation, transfer it in an exchange transaction, or use it in a non-reciprocal transfer.

A renewable energy certificate granted to an entity by a regulator that is determined to be probable of being used to settle an environmental credit obligation would be recognized as an asset, and it would be classified as a compliance environmental credit at initial recognition.

The compliance environmental credit would potentially be zero in its measurement if I as the entity did not incur any transaction costs.

So this is a part of when we think about this credit and to think about well how is it helping fund a portion of my environmental credit obligation liability, the liability would also be measured at zero.

When we think about these items, we do have to think about as well that there may be other GAAP topics that might be relevant. So, for example, if I received some form of renewable energy credit certificate as consideration from a customer in a Topic 606 arrangement, when I have revenue from contracts with customers, well, now I would have to think about the fair value of that non-cash consideration.

And so there may be things where other elements are also relevant to consider as I think about the specific context of the situation.

There may be also where we have to consider the measurement of some of these credits when we are looking at cases like business combinations and to look at the guidance that's contained in Subtopic 805 for our guidance there.

But what we want to focus on principally in our conversation today is the fact that a key part of my accounting is going to focus on that classification. And so when we think about credits expected to settle an environmental credit obligation, those are classified as compliance environmental credits.

If that's expected, if that's the expectation of its use. Other recognized credits are going to be classified as non-compliance environmental credits. This is important for my subsequent accounting because of the fact that compliance credits are not subject to periodic impairment testing.

Whereas non-compliance credits generally are subject to impairment evaluation. They also are permitted to elect an optional fair value model if I have a noncompliance credit.

This classification of my credit between compliance and noncompliance does need to be re-looked at every reporting date as I think about the changes in my business circumstances and the expected usage of these credits.

And so I do need to reassess my asset recognition at each reporting date. And as we may potentially have some form of reclassification from compliance to noncompliance or vice versa, then you do have to think about well, depending on what it's classified at a given date, are impairment considerations applicable?

As a part of my subsequent measurement guidance, as I'm changing my classification of my credits.

So, let's go through and revisit a couple things. At the date that a credit is obtained, we're going to ask is it probable that this environmental credit will be used to settle an environmental credit obligation? Is it separately going to be used to, is it probable it will be transferred as a part of an exchange transaction?

Or is it probable that it will be used in a non-reciprocal transfer? If the answer to that is yes, any of those three are true, then I would go in and say, well, I need to recognize an asset and I need to classify it as either a compliance or non-compliance credit in accordance with the criteria in this new section.

If it is not probable of one of those three things occurring, I would recognize the cost of the credit as an expense as incurred. So let's assume that I have an asset and I have it classified for any environmental credit that's recognized as an asset.

We do also have to look at and say, is it probable that this credit will be used to settle an environmental credit obligation transferred and exchange transaction or used in non-recycle transfers at each reporting date. If at each reporting date at some point it's no longer probable that one of those two three things are true, I would de-recognize the carrying amount of the credit through my earnings. If at the reporting date it is yes, it is still probable from there in my subsequent measurement, I'm going to determine is it probable it will be used to settle an environmental credit obligation? If yes, it's classified as a compliance environmental credit and it's not subject to impairment testing.

If the answer is no, I still have an asset, but it's classified as a non-compliance environmental credit and it is subject to impairment testing.

But I do need to look at initially on the date of obtaining the credit, do I have an asset or do I expense as incurred? And on each reporting date, I'll reassess, do I still have an asset or do I need to de-recognize that asset? And if I still have an asset, is it subject to impairment depending on its classification as compliance or noncompliance?

All right, so let me give an example that they talk about in the illustrations for how to apply these concepts in the FASB codification. Let's talk about a case where I have an entity that might be subject to cap and trade regulatory compliance programs. That program mandates the remittance of emission allowances to a regulator that's based on the amount of the entity's emissions for a compliance year.

So, I may need to remit something at the end of March for the compliance year that ended on the previous December 31st. So, if the compliance year ended on December 31st, on January 1st, I might have purchased 10,000 emissions allowances at a auction that was sponsored by a regulator.

Let's assume I paid \$100 per allowance, so I just spent a million dollars. I also paid \$25,000 in auction fees. At the initial recognition of these credits, I determined that it is probable I'll have to use these emission allowances to settle up on my previous years cap and trade environmental credit obligation because I'm estimating that I will need to actually remit 15,000 emission allowances.

I'll need to remit those as it relates to those items. And so I estimate I'm going to need 15,000 allowances. I just bought 10,000.

But the 10,000 are probable to be used to settle on this cap and trade obligation. They're probable of being used. I bought them in January. I'm probable of using them in March.

These would be a compliance environmental credit that is initially measured at the \$1,025,000, the cost of the allowances plus the \$25,000 in auction fees. And as we look at this at each reporting date, I'm going to revisit and say, are they still probable of being used to settle these cap and trade obligations? If the answer is yes, then I continue to have a compliance environmental type credit.

And there's a variety of illustrative examples for that.

When we look at these compliance environmental credits, right, they're they were initially recognized at cost and they're subsequently carried at cost, as long as that classification of being a compliance credit continues to be appropriate.

Now, let's look at the subsequent measurement of a non-compliance credit. It is measured initially at cost, subsequently at cost less impairment. And I would have to look at impairment each reporting date. If the carrying value of my credit exceeds its fair value, I have an impairment loss. And impairment losses are not able to be reversed. Even if the market recovers later.

As we do think about the non-compliance credits, ones that are not probable of settling an environmental credit obligation.

I mentioned how there is a fair value alternative that's available for the non-compliance credits, that we can use that as an accounting policy election where the changes in my fair value are recognized in earnings.

You do have to qualify for this. It has to be that it's the non-compliance credit and it also cannot be an internally generated credit or a regulator granted credit.

So, I am looking at entities that might actively participate in the environmental market to allow for them to align their accounting as we do think about how I'm actively involved in these markets and I'm looking at economic value changes.

But this is an election that I can make as I think about fair valuing these eligible non-compliance environmental credits. And so there's guidance on how to handle that.

Do I de-recognize credits? Well certainly as I am thinking about these items, it may be that I have a case where I've transferred the credits in a not in an exchange type transaction.

It also may be that an entity concludes that it's no longer probable that a credit will be used for qualifying purposes. And so, I no longer have a qualifying asset. The asset would then be derecognized through earnings.

Credits that I previously de-recognized generally cannot later be recognized again as assets.

I do want to take a few moments to talk not about the environmental credits, where I'm focusing on do I have an asset, but I'm also looking at the liability that exists for environmental credit obligations, which are enforceable obligations resulting from a regulatory compliance program that is focused on preventing, controlling, removing, removing, reducing emissions or some other form of pollution, and they may be settled with environmental credits.

So, these are arising from a regulatory program rather than a voluntary commitment. Voluntary initiatives do not constitute an environmental credit obligation.

When we do have thinking about this liability, liabilities are recognized when events occurring on or before the reporting date create these obligations. And so, it is important that we do look at evaluating obligations.

And I'm going to evaluate these obligations as through the reporting date were the end of the compliance period, even if the actual compliance period ends later. This, in essence, will improve the transparency regarding environmental compliance costs.

When we're measuring an obligation, I'm saying I need to have a liability. You're going to take your obligation and you'll divide it into a funded portion and an unfunded portion. And I am required as I think about the initial and subsequent liability.

I'm using the carrying amount of the compliance environmental credits that holds, and I'm expecting to use to settle that obligation at the reporting date. So, this is the funded portion of the liability. The funded portion is using the carrying amount of compliance environmental credits expected to settle the obligation.

If I have insufficient credits at a reporting date to satisfy this liability, then now I have an unfunded portion that should be initially and subsequently measured at the fair value of the environmental credits necessary to settle the unfunded portion at a reporting date.

There are certain exceptions, but generally we're looking at the unfunded portion is the fair value of credits needed to satisfy remaining obligations subject to some exclusions. Now, if I actually remit the necessary credits to a regulator, then my liability can be derecognized.

So that is important as we think about the classification of my credits, and how does that also affect if I have a regulatory constitution, a regulatory issue, I may have a liability that might include a funded and unfunded portion.

As we do think about economically, the funded portion is based on the credits I have. The unfunded portion is based on the fair value of the credits that I don't have.

And there are included in the illustrative guides some illustrative examples about using your compliance environmental credits and how do I measure which ones I'm actually applying and using if I have to use a method like first in, first out or average cost and settling up on those obligations.

There may, as we think about these items, if I have a voluntary environmental initiative, then it may be as I have these voluntary statements about reducing my carbon emissions since it doesn't result from a compliance obligation, it would not be accounted for under topic 818. If it's a voluntary program, there is no liability to book.

As far as from a presentation point of view, we do need to present my compliance environmental credit assets separately from my environmental credit obligations. Showing a net presentation is not permitted.

I also need to think about are these assets, are they current or non-current as I want to increase the visibility into my assets and liabilities. And there will be disclosure requirements that will provide some qualitative information about how the entity obtained the credits and how the entity is intending to use them.

As we're disclosing useful information to the reader. And if I'm changing my intentions over a period of time, I'm going to disclose the fact that I've made a change from my previous reporting period. There's also, for the assets, there's disclosure requirements. And for any obligation I have for an environmental credit obligation resulting from a regulatory program, there is a listing of things to talk about as we think about how maybe the unfunded portion was measured and any other significant estimates and judgments that are applied in this guidance.

And so the goal of the disclosures for the obligations is also to help users understand what my regulatory exposure is, what are my compliance strategies, and what potentially could be implications on my future cash flows.

All right, so hopefully you've gotten some useful information about these new ASU that is effective for public business entities for annual periods beginning after December 15th, 2027, including interim periods within. And then for all other entities, it would be effective for annual periods beginning after December 15th, 2028. However, early adoption is permitted.

And there is extensive transition guidance that's provided in this ASU to help you with that initial adoption of these new items. It is important that we do an inventory of any environmental credit arrangements, identify the regulatory compliance programs they might be associated with, and to start gathering the data that I might need in order to determine the proper classification and the proper recognition and measurement in accordance with ASU 2026-02.

So hopefully this was helpful for you in understanding these items and hopefully we have some consistency and practice as we do see an increase in the marketplace for these types of credits.

GROUP STUDY MATERIALS

A. Discussion Questions

1. Why did FASB create a new Topic 818 for environmental credits and environmental credit obligations?
2. Why is the distinction between compliance and non-compliance environmental credits important?
3. How does Topic 818 address environmental credit obligations, and why does the funded versus unfunded distinction matter?

B. Suggested Answers to Discussion Questions

1. Why did FASB create a new Topic 818 for environmental credits and environmental credit obligations?

FASB created Topic 818 because environmental credit transactions were becoming more common and economically significant, yet existing GAAP did not provide dedicated guidance for them. Before ASU 2026-02, entities accounted for environmental credits by analogy to other areas of GAAP, such as inventory, intangible assets, or contingency guidance. This resulted in significant diversity in practice because similar transactions could be recognized, measured, presented, and disclosed differently across entities. As environmental regulations, renewable energy mandates, emissions reduction programs, cap-and-trade systems, and voluntary sustainability initiatives have expanded, the need for a consistent accounting framework became more important. Topic 818 is intended to improve comparability and transparency by providing specific guidance for recognition, measurement, classification, presentation, disclosure, and transition. The standard helps financial statement users better understand how environmental credits affect an entity's assets, liabilities, compliance strategies, regulatory exposure, and potential future cash flows. In short, the new guidance responds to a growing area of accounting where decision-useful information had previously been limited by inconsistent practice.

2. Why is the distinction between compliance and non-compliance environmental credits important?

The distinction between compliance and non-compliance environmental credits is important because classification directly affects subsequent accounting. A compliance environmental credit is one that is probable of being used to settle an environmental credit obligation arising from a regulatory compliance program. These credits are initially measured at cost and subsequently carried at cost as long as the compliance classification remains appropriate. They are not subject to periodic impairment testing. Non-compliance environmental credits, by contrast, are recognized credits that are not expected to settle an environmental credit obligation. They are generally measured at cost less impairment, and impairment must be evaluated at each reporting date. If the carrying amount exceeds fair value, an impairment loss is recognized and cannot later be reversed. Certain non-compliance credits may also qualify for an optional fair value model, with fair value changes recognized in earnings. Because intended use and business circumstances can change, entities must reassess classification each reporting date. This classification affects not only measurement but also the transparency of disclosures and users' understanding of the entity's environmental credit strategy.

3. How does Topic 818 address environmental credit obligations, and why does the funded versus unfunded distinction matter?

Topic 818 addresses environmental credit obligations as enforceable obligations arising from regulatory compliance programs designed to prevent, control, reduce, or remove emissions or pollution. These obligations differ from voluntary sustainability commitments because voluntary initiatives, such as self-imposed net zero goals, do not create environmental credit obligations under the standard. A liability is recognized when events occurring on or before the reporting date create the obligation. The obligation is then divided into funded and unfunded portions. The funded portion is measured using the carrying amount of compliance environmental credits the entity holds and expects to use to settle the obligation. The unfunded portion represents the remaining obligation for which the entity does not hold sufficient credits and is generally measured at the fair value of credits needed to settle that portion. This distinction matters because it provides a clearer picture of the entity's current compliance position. It shows whether the entity has already obtained credits needed for settlement or may need to acquire additional credits, potentially exposing it to market price changes and future cash outflows.

AUDIT & ACCOUNTING PART 2

Best Practices for Effective and Efficient Auditing: Performing Tests of Controls and Substantive Tests

This course examines how auditors can design engagements that are both effective and efficient by aligning tests of controls and substantive procedures with assessed risks of material misstatement. The presentation explains when control testing is worthwhile, how control reliance affects substantive audit work, and how analytical procedures and tests of details can be combined to obtain sufficient appropriate audit evidence. Participants will also explore attribute and variable sampling, sample-size considerations, stratification, deviation evaluation, and dual-purpose testing. Throughout the program, the instructor emphasizes professional judgment, cost-benefit considerations, and documentation that clearly connects identified risks to the procedures performed and conclusions reached.

Mr. Christopher K. Martin

Hi, everybody. Welcome to today's presentation. I'm really glad that you're here today. Before we jump in, let me just start with a really quick reality check. So, most of us were trained to audit everything, document everything, and then worry later about efficiency. And while the standards haven't gotten any lighter, the expectation today is very clear. Risk-based, focused, defensible auditing. Okay, without burning out your team or blowing up your budget.

So, today's session is all about that balance. We want to talk about effective and efficient auditing, specifically when it comes to test of controls and substantive tests. We're going to be focusing on those two particular areas. So, we're going to be talking about why we do what we do, when it makes sense, for example, to test controls.

And how that impacts the subset of procedures. And just as important though, when not to over-audit. Okay, so I want to focus in some of those areas. So, I'm going to be sharing some best practices, some common pitfalls that we see in peer reviews, and how to make some more practical judgment calls that experienced auditors make every day. The kind of things you don't always find spelled out in the standards. So, as we go through the slides, I encourage you to think about your own engagements and just ask yourself.

Would this actually add audit value on my jobs, or is this just habit? So, by the end of today's session, my goal is that you're going to walk away with some clearer decision making around controls, maybe some smarter substantive testing and documentation skills that helps you tell more of a clean, defensible audit story. Now, before we dive in, just let me give you a little bit of context.

So, just like you, I'm a CPA and I've spent most of my career in the trenches, you know, planning audits, supervising teams, dealing with documentation questions, and responding to peer review comments that always seem obvious, it seems like at least after the fact. So, after the years and over the years, I'm working with lots of you and working with different firms all over the country. One theme keeps coming up over and over. Auditors typically don't struggle with effort.

Okay, we struggle a lot more with judgment calls. So, my focus today isn't again on quoting standards. You already know where to go to find the answers that you're looking for. Instead, I want to share how experienced auditors actually think through test of controls and then think through the resultant substantive procedures to gather the evidence that we're looking for to help us make that opinion. Is this area, is this assertion free of material misstatement?

Remember, we're the smart ones in the room. We're going out gathering evidence that can convince us that something is free of material misstatement. And then our jobs then as an intern or as a staff person or a senior or a manager or a partner is to convince other members of our engagement team that it is free of material misstatement. Hopefully, then once we can do that for all the financial statement line items, it makes it a lot easier to make that opinion call for the financial statements taken as a whole whole, right?

So, as we go through this, okay, we've spent a lot of time teaching, presenting. So we see where firms tend to over audit, under audit, or miss opportunities to be more efficient without increasing the risk. So, I want to spend time in that particular area. So think of today less as a lecture and more as a conversation, maybe between colleagues.

Now you'll notice that there are a lot of slides. So, I may not spend a lot of time on every single slide that's out there. We're not going to have time to do that.

So, let's take a quick look at where we're going to be headed today. By the end of today's session, you should be able to do four things more confidently. First, how to select and test key controls. Remember, we're not going to test all controls, but the ones that actually matter from a risk perspective. So, I want to talk about how to identify those and when it's worth the effort to actually go about testing them.

Second, we want to plan the extent of our substantive testing, again, based on our risk assessment and ultimately our conclusions. On those controls in bullet point number one. So, in other words, how to let your planning work more effectively and pay off later in the audit.

Third, we want to sample appropriately for both test of controls and substantive test of details. So, I want to talk about how sample sizes change based on our risk, frequency, and reliance. And then finally, we want to document those test of controls and substantive procedures in a way that tells that clear audit story. One that makes sense to a peer reviewer, a regulator, or maybe someone that's newer to your engagement.

So, remember, as we go through these objectives, notice a common thread. Everything ties back to risk. If you understand the risks and document you're thinking clearly, the rest of the audit tends to fall into place. So, if you've ever felt like your audits were technically compliant, but maybe not as efficient as they could be.

These objectives are designed to help close that particular gap. Remember, when we talk about a risk-based audit, it has these three different components to it. Remember, we go about understanding the entity. Okay, so what does my client do? How do they go about doing it? And then we take that information and we assess the risk, where we come together as an engagement team and we talk about what risks we're concerned about this year and how big of a risk they are. This is where we want to focus our time and attention.

So those other presentations focus on these first two steps. So today we're in the area of responding to that risk. Now that we know what those risks are and how big of a risk they are, right? What procedures now do we want to implement that will actually address those particular risks?

So another way of showing these, okay, is this hourglass graphic that you see here on the screen, where we perform those risk assessment procedures. Remember, all of those risk assessment procedures are what we do to understand the client, to identify those potential material risks. We bring those potential material risks to our engagement team discussion, where we together determine these quote unquote true risks and then use our professional judgment to assess those risks as high, medium, or low, remembering that this is our judgment call, right?

All we have to do is document our rationale in our work papers. That way, a peer reviewer or someone coming in to review our work after the fact understands why we are doing what we're doing. We're going to spend a little bit of time in this risk assessment as we talk about assessing what we call the control risk within the audit risk model. And then we're going to focus the remainder of our time again on this third step where we're performing these further audit procedures.

We're designing those work programs to respond to those assessed risks. Then we're executing those work programs in order to, again, gather the evidence that we're going to need in order to opine whether that particular area is free of material misstatement. And as you notice at the bottom, every component of this audit plan then must be clearly documented in your work papers. We're providing this linkage between the knowledge that we gather, the risks that we identify and then ultimately what we did or what we plan to do to then clear those particular risks.

Right now, as we move into this particular area, we're going to be focusing for at least the first part of our webinar here today on the internal controls component. Now, we're going to see this particular graphic several times through today's presentation.

This graphic I like to refer to oftentimes as the Seesaw graphic. Now as we perform these further audit procedures, or as we design these further audit procedures, notice we have two choices. Do I want to test the operating effectiveness of internal controls, or do I want to take more of a substantive audit approach? We're going to be putting these two choices on a seesaw. So let me put my fulcrum here in the middle because there's an inverse relationship at work here.

If I decide, for example, to go about testing the operating effectiveness of the client's internal controls. And I find that those internal controls are effective, they've been operating effectively throughout the period, then I get to rely on those. So, my reliance goes up. And so therefore, I'm allowed to reduce the amount of substantive testing that I'm going to be able to perform. Okay.

And the opposite is true, right? If I don't test those internal controls, either because I just don't want to, or because maybe the client doesn't have well-designed internal controls. Or when I did my implementation procedures, I was able to determine, hey, my client's not really documenting too well their performance of internal controls. So there's not going to be a lot of evidence throughout the period about the operating effectiveness of those controls. I know that I'm going to be relying less on those. Right.

And so therefore I have to spend more time and effort on the substantive approach towards my audit. Now, there's not going to ever be a time where you can go test those internal controls and you go, hey, those internal controls are working so well that I don't have to do any substantive tests. That's not going to ever be the case. You're always going to be performing some substantive tests. It's either going to be a lot or a little, right?

And this again is going to be one of those professional judgment calls. So let's spend some time then talking about how to go about testing the operating effectiveness of these internal controls. Now, when we talk about testing internal controls, before I move away from this particular slide, remember by the time that we get to this particular decision point, and I'm going to back up here on one of our slides, remember, as part of the risk assessment procedures we've already gone out as an engagement team and identified the client's significant transaction cycles. Okay.

So, we've identified, for example, hey, I need to understand the internal controls over revenue recognition, and I need to understand the internal controls over the client's financial close and reporting cycles. Those two cycles always required by GAAS. Okay.

So, think about it from that standpoint. We have revenue recognition. And I'll put up here just financial close and reporting. Those are the two that are always going to be on our list of in of areas that we have to quote unquote understand internal controls. Remember, understanding internal controls means that we go about assessing the design effectiveness and then verifying the implementation of the key controls within those particular cycles.

Now, your engagement team may have, during these risk assessment procedures, identified other significant cycles that you wanted to also understand the internal controls over. So, for example, maybe you added cash receipts or cash disbursements or payroll, okay, or other cycles again that you've deemed to be significant.

If you have a risk of material misstatement, okay, in a particular area, let's say in inventory, and you identify that risk of material misstatement within one of the financial statement assertions, let's say it was the existence and the valuation assertion, those two assertions become what we call relevant assertions. And because we have relevant assertions within that inventory area, we need to look at the transaction cycles that relate to those two assertions within inventory.

So, for example, with the existence of inventory, that probably leads me to the purchasing cycle about how my client goes about purchasing that inventory. Remember, that's going to result in a debit to inventory and a credit to accounts payable. They purchased and received the inventory. It also then relates me back to that revenue cycle that I highlighted up here for you, so that when they sell a particular inventory item, right, this is where they would debit accounts receivable, credit revenue, debit cost of sales, and then credit the inventory. So this is the credit side of that inventory transaction. So again, helping you understand what those relevant assertions are going to be and the identification of those risk of material misstatement helps you identify those significant transaction cycles that you're then going to further understand the internal controls over. Okay.

But remember, for today's discussions, we've already identified these, we've already assessed the design, and we've already then verified the implementation of the key controls within those cycles. We're at the point now of determining: do we want to test the operating effectiveness of those, which essentially is just taking those verification of implementation procedures, okay, where we go out and we verify that the control was real and the client really has put those into operation.

Now we're just determining, hey, have they been doing this throughout the period? Is there evidence, for example, that that, let's say, the order entry clerk has been verifying that that's a valid sale in January? Well, what about in March? What about in June? What about in October? So, he or she has been performing that particular control throughout the entire audit period. That's what we mean by testing the operating effectiveness of the internal controls.

Okay, so the first question we want to ask ourselves, hey, should we test controls? Unless there's a regulatory requirement to do so. So, let's say, for example, you're auditing a governmental agency and there's a regulatory requirement within that governmental agency that the audit must test certain internal controls. Or you're performing an audit over a publicly traded company.

So, the PCAOB's rules kick in. It says, hey, you know what? You have to render an audit opinion on the effectiveness of this company's internal controls. So therefore, you know that you have to test those. Outside of those regulatory requirements, this is going to be a choice for you. Do we want to or do we not? Okay.

So that's the question that we're trying to answer here. Should you test those internal controls? So, the first question we're going to ask ourselves is: what is the inherent risk for the assertion or the assertions that we're concerned with?

So let me share kind of a bonus slide here for you. I don't think this one shows up in your materials here today, but most of you are probably familiar with the audit risk model. And in the audit risk model, okay, remember we're trying to determine ultimately how much work do we need to do over here? What's going to be the nature, timing, and extent of the procedures? This is what we're going to be talking about when we get to our substantive procedure discussion a little bit later in today's presentation.

But we're going to be talking right now about this control risk component. And where we start with that, as you saw on that slide that was just up for you, is what is the inherent risk? So, let's say, for example, we're auditing the financial statement line item, accounts receivable. And so we put our financial statement assertions down. Let's say we have existence, we have rights, we have completeness, we have valuation, we have accuracy, we have classification, and we have cutoff, the seven financial statement assertions.

Based on what we know about this particular client and our understanding of how the client creates these debits to accounts receivable, okay, i.e., through that revenue recognition cycle that we just discussed, we might determine, for example, hey, you know what? The existence assertion for accounts receivable carries a high inherent risk, meaning that there's a higher risk of error or fraud in that particular assertion. Okay.

The rights assertion might carry the same degree of inherent risk. For the same reasons that the existence assertion is high, the completeness assertion might therefore be low. Remember, existence is all about overstatement. Completeness is about understatement.

Valuation is asking the question is there a net realizable value concern? What's the valuation of accounts receivable? And let's assume that we use our professional judgment and we determine that the valuation assertion carries a higher degree of risk. Let's say that the accuracy assertion carries a moderate risk, the classification, a low risk, and the cutoff assertion a higher risk.

So now that our engagement team has identified the assertions and has assessed the inherent risks associated with each assertion within accounts receivable, I would ask my engagement team, hey, are there any good internal controls in place that might mitigate those particular risks?

So, for example, let's say that I'm concerned that accounts receivable may be overstated because the salespeople who are earning a commission and they're subjected to a sales quota and they participate in a bonus program, they may create a fictitious sale. If they create a fictitious sale, obviously revenues would be overstated, and the resulting accounts receivable would also be overstated.

So we go, okay, well, how would a salesperson create this fictitious sale? Well, maybe they create a sale for a particular customer that's not valid, right?

So, George is our customer. We're the salesperson, and George hasn't ordered anything but because I need it for my commission or my sales quota or for that bonus, I just fake it, right? I just turn in a sales order for him.

Well, maybe the order entry clerk goes through and validates every sale over a certain dollar amount by calling George and saying, hey, George, thank you so much for your order. I just wanted to go through the order and verify all of the different components. You ordered product XYZ, the price is this much, you want it by this particular date, et cetera. So that's our internal control: is this order entry clerk validating all of the different portions of the order? Well, if that particular order entry clerk is doing that, that really lowers my risk that there could be a fictitious sale.

Someone is validating all of those different sales orders that get turned in. So, if I could go out there and determine that that's order entry clerk is doing that throughout the year and gather evidence, then my control risk over here might drop down to low. Okay.

Because those internal controls work. They've been working throughout the period. So that's the benefit of testing those controls is the ability to lower this control risk down to moderate or to low. How does that help us? Well, if I have a high inherent risk and I have a low control risk, then my ROMM, my risk of material misstatement, when we combine those, is more in the moderate area.

Ultimately, as an auditor, we're going to be taking all of these risks of material misstatement. In this particular case, we have a moderate risk for the existence assertion of accounts receivable. And then we say, okay, if I have a moderate risk of material misstatement, what am I going to do from an audit procedural standpoint, from a work program standpoint?

What kind of procedures do I need to perform on accounts receivable to validate the existence assertion. When do I need to perform those particular procedures? And how much of it do I need to do? So, I'm passing this risk through my work programs, okay, my detection risk procedures, as they're also known, hopefully, in order to reduce that moderate risk down to an acceptably low level. Okay.

And if I can do that for every financial statement line item and every relevant assertion within those financial statement line items, then it's easy for me to draw this particular conclusion at the end of my engagement that now these financial statements are also free of material misstatement. I've lowered my audit risk, the risk that I've missed something big and I've given the wrong opinion down to a sufficiently low level. Okay.

So again, if we go back to the slides that we were just looking at, okay, about internal controls, what is the IR for the assertion or the assertions that we're concerned about? We'll see on the next slide that if the inherent risk is already low, there's not going to be a lot of benefit to testing the internal controls related to those. Because remember, ultimately, we want to get to this low risk of material misstatement.

And if the risk of error or fraud is already low, let's say, for example, here with this completeness assertion, then we're probably already at a low risk of material misstatement. We're not going to be doing a lot of work anyway, because the ROMM is most likely already going to be lower.

So, one of the best efficiency and effectiveness techniques is to really use your professional judgment to get these inherent risks right first. What do you really feel is the risk of error or fraud in that particular area based on what you've learned from the client in those risk assessment procedures that we perform during the planning phase? Okay.

So, get the inherent risks right first. That's the biggest benefit that you can get. And remember, you can't be wrong because the inherent risk assessment is your professional judgment.

A peer reviewer is not going to come in and say, hey, Chris, what are you doing? Why did you call the completeness assertion low? Are you crazy? That should have been a high risk. They're not necessarily there to question my professional judgment. They're simply going to go, hey, Chris called the completeness assertion a low risk. I wonder why. They're going to go into my work papers and read my rationale and go, here's why he thought that that risk was low. Gold star for his documentation. Let's move on.

I wonder what he did to test the completeness assertion based upon that. So get the inherent risk right first. Once we've determined, hey, my inherent risk is worthy of lowering by testing those internal controls, then I need to step back and say, hey, are there good internal controls that would be worthy of testing? So, are they designed effectively? Remember, by the time that we get to this particular point, we've already assessed the design effectiveness and we have verified the implementation of those key controls.

That understanding of those internal controls then helps us understand how does my client evidence that those controls were performed? So, we have to ask ourselves: is my client documenting their performance of those internal controls so that we're able to get some kind of persuasive evidence that that control is operating effectively?

If you can't, you don't want to waste your time going about testing controls because there's not going to be anything there for you to necessarily look at. Remember, because we're trying to validate that these controls have been operating throughout the period, you're most likely going to have to use the audit evidence technique called inspection. We're going to be inspecting for evidence that those controls were performed last January, last February, last March, for example. Okay.

So is my client properly documenting their performance of those controls? The next one here, say, okay, yes, we've got good inherent risks. Yes, the controls are designed effectively. Yes, there is persuasive evidence. Well, ultimately, okay, if we go back to our seesaw diagram from just a moment ago, okay, remember when we test these internal controls, I'm hopefully going to be able to rely on those internal controls so that I can reduce those substantive procedures.

So, if you're going to be resistant to it and you're going to go, you know what, no matter what those internal controls are, I'm going to be hesitant to reduce my subset of procedures, then don't waste your time. You've got to be open to this reduction in substantive procedures. Now we'll be talking about how you go about reducing them a little bit later. So, for example, maybe you're increasing scopes.

Maybe you're changing from test of details to substantive analytics. Maybe you're lowering your sample sizes, for example. We'll be talking about all of those in a little bit more detail a little bit later in the presentation. Now, we also want to test the controls when, okay, all of these are true, but we believe that we can get stronger evidence from it. Remembering you're not required by GAAS to test the operating effects of internal controls.

You may be required through regulatory requirements, but outside of those, this is a professional judgment call for you and your engagement team. All right. So, from this point forward, we're going to assume, yes, we want to test the internal controls. Now let's talk about how we go about doing it. Now, as we just mentioned, we only want to test them when the inherent risk has been assessed at higher than low. Okay, so we're at high or moderate.

Now, we don't have to test every control. We get to test the key controls. So, let's say, for example, and if I go back to my audit risk model, I might say, hey, you know what? If I were testing the internal controls over accounts receivable, I may say, you know what, I don't really want to test the internal controls over the rights assertion or the completeness assertion or the valuation or accuracy or classification or even cutoff. I only want to test the internal controls over the existence assertion.

So, you get to pick and choose which assertion you want to test the controls over. So, for example, you see here that the valuation assertion also carries a high degree of inherent risk. Hey, Chris, why aren't you testing those internal controls? And I may go, well, you know what? I could, I could, but my valuation work to take this high risk through my work programs is not going to be that difficult. I can probably easily do substantive test work to get that particular risk down to a sufficiently low level.

So therefore, because I'm not doing a lot of extra work substantively, I'm just going to focus on substantive tests. But to test the existence assertion, I may have to like say confirm a whole bunch of different accounts receivable. And I don't want to have to confirm, you know, 90 accounts receivable. I'd rather confirm just 10 of them. Well, maybe I want to test those internal controls in order to get that particular reduction.

Okay, so I just wanted you to understand kind of the professional thought process that you go through in determining what those key controls are going to be. Remember, as we're testing them, the testing, just like everything else, consists of some inquiry of the four ways to gather audit evidence, which is inquiry, observation, inspection, and/or reperformance remembering that inquiry alone is never sufficient audit evidence.

So, we always have this plus, right? This means that we are corroborating. That's what the word corroborating means is we're not just relying on what the client tells us, but we're corroborating it by also performing maybe an observation where I watch that happening. Or I inspect evidence of it.

Maybe I look at, you know, where the order entry clerk signed off, or maybe initialed, or put a tick mark or a stamp or something like that on the order entry that says that he or she validated that particular sale, or maybe I re-performed that same control in order to see if I got the same result.

Now, when we decide that we want to test the operating effectiveness, how many do we need to do? Okay, and we're going to be talking about this as we get into the sampling discussion here in just a few minutes.

The number that we test depends on a lot of different factors. Primarily the size of the population, which in internal control speak means how frequently does that control happen throughout the year? So, if I were to, for example, consider that order entry clerk calling each customer to verify the components of the sales order, that's happening for every sale that's out there.

So that might be happening hundreds or thousands or even maybe tens of thousands of times a year. That is what we mean by the frequency of operation. But let's say that we are working with a smaller company, a smaller entity, and maybe the owners get involved on a monthly basis and they're going through the monthly sales report and they're looking at the various sales throughout the month and they're questioning certain numbers of sales or the magnitude of certain sales.

And so that particular owner's review might then uncover a material error or material fraud. And if that was our key control, that one only happens monthly. So, there's only 12 in my population, okay, rather than maybe tens of thousands. So obviously I would be able to test fewer of those items because it happens less frequently throughout the year. My population is smaller.

Now, as we saw on that Seesaw diagram, remember we have an effect then on the substantive testing. And we want to make sure that we take advantage of the results of our test of controls. Remember, it's going to reduce the risk of material misstatement. Remember that IR times CR in the audit risk model equals my risk of material misstatement.

It can also reduce my sample sizes. It can increase the scopes. It could allow analytical procedures that have less precision or corroboration. And it can allow substitution of tested details for analytical procedures. Okay. Remember, just a few minutes ago, I shared with you this little seesaw diagram. Here's that more expanded version that I wanted to share with you that we saw the same seesaw just a moment ago, right here between internal controls and substantive. And we had our arrows up and down, right? And I told you you're never going to perform internal controls and eliminate your substantive tests. You're either going to increase them or decrease them.

Based on the results of your test of controls. But when we perform our substantive test work, we have a couple of choices here as well. I can do analytics and/or I can perform tests of details. So, I'm just going to put and/or. Now notice I said OR here because my analytics can be greater, okay, or provide enough evidence that I could eliminate my test of details if I had an analytic that I thought was good enough. So, there's also an inverse relationship at work here. Okay.

If I can go out there and perform a subset of analytic that gives me enough evidence that I feel comfortable with that, hey, that particular risk has been mitigated, then I can reduce and/or eliminate my test of details. The opposite is true though.

GAAS does not require you to perform a substantive analytic. So, if you don't perform analytics, okay, or if you performed an analytic and something seems off and the client doesn't have a good explanation as to why that particular number is different from your expectation, then you're going to perform greater amounts of test of details. So again, an inverse relationship at work here.

So, if my internal controls work, okay, and I'm able to reduce, for example, my substantive test work. And then as I'm performing my substantive test work, I perform an analytic, and my analytic says, hey, everything's looking pretty good. I can reduce the amount of test of details or possibly even eliminate it. Let's go back to our example here then on accounts receivable. Let's say that we tested, okay, and let's talk about the existence assertion.

Okay, we're testing accounts receivable existence. We've tested those internal controls. We found that they work. I know I can reduce my substantive test work. And let's say that from an analytical standpoint, I go, hey, you know what? Let's perform the AR turnover ratio. Okay, that's going to help me gather some evidence about the existence of accounts receivable.

So, the AR turnover ratio tells you how often your client's accounts receivable turnover, right? How quickly, they're able to collect on those accounts receivable. And let's say that they collect them monthly. Okay, it turns over 12 times per year. That means that they should have that one month's worth of sales in their accounts receivable. So if one month's worth of sales is \$100,000, let's say, and you go look in their general ledger and they've got \$95,000 worth of accounts receivable, you go, wow, they're almost right on target with where I thought they should be. Right? So therefore, maybe I could reduce my test of details. Could I eliminate it? In this particular case, the answer is no, because there is a GAAS required test of details related to accounts receivable existence. Okay.

And that is that they you must confirm, right? You have to confirm. So I go, okay, I can't eliminate my test of details, but I could reduce them, right? I can reduce the number of confirmations that I have to do. How would I do that? Well, maybe instead of sending out a confirmation to every customer balance greater than \$1,000, maybe I send out a confirmation to every customer balance greater than \$10,000.

So, I could reduce the amount of tested details by simply doing that. Or instead of scoping, okay, maybe I decide to choose judgmentally rather than using a scope to select those confirmations. Maybe, for example, I judgmentally decide I'm going to send a confirmation out to every accounts receivable for every salesperson that just barely met their sales quota for the last month of the year.

Okay, because those might be more risky than those for those particular salespeople who always meet their sales quota, for example, right? So that's just one example of maybe how you might use judgment to select those. If you didn't use judgmental or scoping, maybe you are going to use sampling then. And maybe you use a lower sample size. And again, we're going to get into how we determine our sample sizes here just a little bit later in the presentation.

So that's how you can come up with the impact on those substantive procedures that we were just talking about here by allowing analytics with less precision or corroboration or substituting those test of details for analytical procedures, unless, again, there's a GAAS requirement. Chris, what are the GAAS required test of details? I don't think this slide is in your materials. So again, take note of this one.

These are the GAAS-required subsidy procedures. Anything outside of this is up to your professional judgment. So, notice the confirmation of accounts receivable is a presumptively mandatory requirement. A peer reviewer is going to go in and look to ensure that you've confirmed accounts receivable.

Hey, Chris, isn't there an exception to the rule? Yes, there is. There are exceptions to when you don't always have to confirm accounts receivable. But because it's a presumptively mandatory requirement, if you don't confirm, you better have some kind of documentation in your work papers, okay, that lets the peer reviewer know I know that confirmation of accounts receivable is a presumptively mandatory requirement, but we met one of the exceptions to the rule.

Here's the exception that we met, and here's how we knew that that exception was applicable in this particular area. All right. All of the others that you see here are gas required test of details. So, you could not eliminate the test of details through substantive analytics. You must have some kind of test of details for each one of these particular items.

All right, moving right on along then. So, as we talk now about testing internal controls, okay, remember one through five, we've already done up to this point in time. We've evaluated the design effectiveness and verified the implementation of the entity level controls. We've identified the significant transaction classes.

We've obtained a process narrative for each one of those significant transaction classes and then we have evaluated the design effectiveness of those activity level controls. We've picked out the key controls within those particular areas, and we have verified implementation of those. If we want to test the operating effectiveness, then it just simply is an expansion of this verification of implementation.

I saw, for example, when I did my walkthrough that that order entry clerk was calling those customers to verify the components of that order entry form. Okay, they did it the day that I was there. Now, okay, I'm just doing the same thing, but I'm ensuring that did they do it last January, February, March, et cetera, based on which ones that we've chosen from that overall population. Now this question then in number six is saying, is it a viable option?

Well again, remember, unless there's a regulatory requirement to do so, it's a professional judgment call. The first one, what's the cost benefit? Remember, we have that seesaw swinging. So, if it's going to take you more time and effort to test the internal controls than it would be to test it substantively, then by all means, skip the test of controls and just do the substantive test work.

If you think there is a cost benefit to doing it, okay? Then we want to make sure, hey, you know what? Are we going to be able to get the evidence that we need in order to lower that control risk down? And are there any known deficiencies that are going to prevent us from being able to get the evidence that we actually need?

So, let's say that all of this is met and we want to go forward with test of controls.

So, we're going to be sampling that population. Remember, the population here is the frequency of the operation of those particular controls. Now we're going to be talking about variable sampling a little bit later when we talk about subset of test work. So, I'm to skip this discussion for now, and we're going to focus on what we call attribute sampling. Attribute sampling is used in internal control work.

Attribute sampling evaluates the occurrence of an event regardless of the dollar amount of the transactions. Okay, so attribute sampling is answering a yes or no question. Did the control operate as designed? Yes or no? Okay, so we're not measuring dollars here, we're measuring occurrence.

Typically, as you see there in that first bullet point, it's commonly used for tested controls. It's often used in compliance with policies or procedures kind of work as well. And I know a lot of you who do governmental work, you'll use attribute sampling to determine compliance with various governmental regulations, for example.

In this attribute sampling, we're evaluating things like deviations. We're talking about deviation rate versus a tolerable deviation rate. So, for example, one missing approval would be the same as any other missing approval. And the size wouldn't matter. It doesn't matter the dollar value.

Now, when we get to variable sampling a little bit later, that is going to be talking about a dollar-based question. How big is the particular error likely to be? That's that extrapolation, for example, or that projection of an error to the overall population that we'll be talking about a little bit later. Now, this particular slide is just here to kind of help some of you who maybe want to understand a little bit better of how you might document some of this work.

And if your firm already has some practice aids and things like that, by all means, use those particular items that are available to you. But we can notice here, okay, the types of things that we're going to be documenting are what is the internal control? Okay, what is that control objective?

What is that control trying to achieve? Did we test it previously? Because remember, if you test internal controls, the standards allow you to get into a rolling rotation. You have to test those controls every third year. So maybe you tested it in a previous engagement. Did you test it in the interim date?

Those internal controls don't necessarily have to be tested at the end of the year. Maybe if we had a December the 31st year in client, we might be out there testing internal controls for January through October. And then we just have to update that the November and December internal controls at the end of the year. Which assertion or assertions is that particular control looking to help test? What procedure or procedures did we perform to test it? Who performed it? When did they test it? Ultimately, was that control operating effectively? And here's your work paper reference. Remember, this documentation is allowing someone who is cold to your audit.

Okay, whether that is the senior or the manager or the partner or the technical review partner or maybe the peer reviewer to be able to come in and understand exactly what you did. And if they so choose, to be able to, and this is the key word, reperform your work with the assistance of your client. Okay, is that work reperformable based on the way that you documented it? And if you have all of this information present in your work papers.

Most likely you have met that reperformance standard. Now, the next thing that we want to do then, okay, is how many do we have to do? Now we said a little bit earlier the population size is going to be based on the size of that population, which is the frequency. Okay, so we have to define the population. So, for example, if I were testing whether or not there were good internal controls over the existence assertion for those revenues and therefore accounts receivable.

And we said the control is that order entry clerk checking those sales order forms. Well, my population definition are all of the sales order forms throughout the year. So, you have to define the population and then make sure that you have them all. How do we know that we have all of the sales order entry forms from the beginning of the year through to the point in time that we're testing those internal controls? And then that helps us determine.

How big it is, how many of those happened. We also then need to say, okay, am I trying to get the control risk down to moderate or low? If I want to get it down to moderate, obviously I would test fewer items than if I wanted to get it down to a low level. We also have to then determine: well, what's a deviation? And in this particular case, a deviation would be a sales order entry form where there's no documentation that the order entry clerk actually validated the information with the customer.

So, a deviation would be, hey, yeah, I've got an order entry form. No one signed off on it, or that tick mark is missing, or there's no evidence that that order entry clerk actually did it.

Now, we're also going to determine, well, of all of that population, how many are okay with me? What's my expected number of deviations from that particular population? Now we'll see this all in a table coming up here in just a moment. Now we talked a little bit earlier about the frequency of those particular controls. And I mentioned a monthly control where that owner is looking at that monthly sales report, for example. And I said, you know what? Because that owner's doing that monthly, right? That's considered an infrequently operating control.

This particular table shows up from there, and there's a reference to the AICPA publication on that. And it says, hey, if you've got a monthly control, you only have to choose two to four of those from throughout those particular months. So, if I have this monthly control, I might say, hey, I want to go and see if there's evidence that the owner reviewed that monthly sales report in June.

And I want to see if they did it in September. Done. Right. Now, if I wanted a higher level of evidence, maybe I test four of those particular months. If it was a quarterly control, I have to do two. If it's semi-monthly, three to eight. If it's weekly, I would do five to nine. So, when you're choosing which controls are the key controls, I like to try to err on the fact that I would like to use a more infrequently operating control rather than a more frequently operating one, because it's going to make my test of controls that much more effective and efficient.

Okay, I get to do fewer items. Let's say, for example, we were looking at payroll. And so I go, okay, gosh, there's a lot of different controls that might happen within the payroll cycle. Let's say, for example, someone is recomputing the number of hours worked from all the time calls.

And someone else is making sure that they recompute all of the different hours that were worked. And someone else makes sure that the appropriate wage rate was applied for each particular employee, for example, right? So, there's a lot of different controls that happen at a really low level. So, there's a lot of those happening throughout the year.

But we also have a departmental manager who, let's say, has 20 employees in his or her department. And if they were to look at the bi-weekly payroll, they might be able to use some analytical procedures, for example, to determine if there's a material error or fraud within their payroll cycle. Okay, like for example, somebody didn't come to work three days this payroll cycle, but you know, that's not reflected in the number of hours that were worked for that particular employee. And because I only have 20 employees in my department, it would be easy for me to determine that. Okay.

I might go, wow, I really like that bi-weekly control rather than that transaction level of control that happens very, very frequently. So again, that might help you get better at choosing a better key control, a higher-level type of control. Versus, okay, if you are looking at the frequently operating controls, okay, those that happen very, very frequently, higher than, for example, the ones that are here: weekly, semi-monthly, monthly, or quarterly, okay, then we would use this other table.

Now, the way that this works, it says, okay, I've got a, let's say, a large population, let's say greater than 200 items in that population, I want to get down to a low control risk. I'm okay with one deviation. So therefore, I have to choose 60 items out of that entire population.

If I only wanted to get to a moderate control risk, notice I only have to do 40 of those particular items. So, this is just go to the table, match up your desired level of control risk.

Okay, match up your population size, determine how many deviations you're okay with, and then find it in the table itself. Okay, now notice that two deviations is the maximum number that you could tolerate. So, if you found, for example, three deviations, then this internal control does not operate as designed.

And so therefore, it would fail the test of controls. You would place no reliance on that, and you would rely solely on your substantive audit procedures.

And again, this information comes directly from that AICPA publication called Audit Sampling, where you can get a really detailed explanation of how all of this works as well.

Now, no, what happens if we found some exceptions? Okay, in this particular case, deviations. So, if an unexpected deviation is found, we can decide again to place no reliance on the control. So therefore we would control the risk, control risk high.

Or we could assess the control risk at the level supported by those sample results. So, if I back up one slide and we were going for this one, let's say we were hoping to get a low level of audit risk. And I was using this one deviation is okay. And I'm testing these 60, but no, I found two deviations. Well, I know that I failed. I can't get down to a low control risk but using the results of that same work, two deviations, okay, with a sample size of 60. Notice here, okay, I could get down to a moderate control risk, okay, without having to do anything differently from that.

I can use that same information, that same sample, okay, but knowing that I had two instead of one, I get to a moderate rather than a low.

So, we could assess the control risk at the level supported by the sample results, or I could resample. Okay, I could pull a new sample.

Now, some additional considerations for unexpected deviations. Just really quickly here. You could conclude on the achieved level of control risk. Again, if no unexpected deviations, then it's the same that you had planned.

Okay, so for example, we were going for low and we achieved a low level of control risk. I would need to determine whether a deviation is a deficiency, a significant deficiency, or a material weakness. So, if the client failed to do something, I have to use my professional judgment. Okay, go do a little bit of research to learn a little bit more about AU-C 265. That kind of helps you with the thought process about determining whether something is a significant deficiency or a material weakness. Okay.

Consider whether the deficiency indicates an indicated risk of material misstatement. Most likely it is. And is that deviation indicative of fraud?

Okay, so again, we want to think about the reasons for a particular deficiency and then step back from that and determine the bigger picture implications that are present with that.

Now, if those controls operate effectively and we say yes, right, great. Remember, we get to perform less substantive work. Okay, and I showed you this in the seesaw diagram a little bit earlier. Maybe we have higher scopes. Maybe we use lower sample sizes when sampling substantively, we could get by with weaker evidence in our substantive analytics.

And maybe I'm performing more interim work throughout the engagement rather than focusing all of my work towards the end of the year. Now, this particular slide that's coming up here, these are just some common test of controls, just to kind of give you an illustration and an example for the revenue cycle. And again, these are also reflected in the auditing standards where they give you a lot of different types of controls that you might consider within various areas.

These just happen to come from the ones over revenue. And I don't want to go through all of these because remember, you're the one that's going to determine which of these makes sense based on which controls you've chosen to be the key controls, given your understanding of your client.

Same thing here for segregation of duties, for example, over accounts receivable, just some things that you might consider as controls that you might decide to test.

Now remember, we talked about a little bit earlier. You're not required by the auditing standards, at least by GAAS, to test those internal controls. So, it is a professional judgment call. Do you want to go with a hundred percent substantive approach, or do you want to choose some kind of control reliance strategy? Now, sometimes we don't have a choice here.

We might have a situation, for example, where I can't think of a substantive procedure that by itself would not give me enough evidence to be able to opine that that particular area is free of material misstatement. Let's say, for example, that I am auditing a 401k plan. And within that 401k plan, there are internal controls that happen that are outside of my client's operations.

So, let's say, for example, a participant in that 401k plan can make investment decisions, et cetera. Right. And so therefore, there's not really a substantive test that I could perform that would give me enough evidence that that report is correct. I would have to rely on the internal controls over that particular 401k trustee report. So, I would need to test the internal controls over that.

Now, locally, in the situation of like a 401k plan, oftentimes there's those SOC reports that we can order, right? That we can rely on where another auditor has gone out and tested those internal controls and gives us a SOC report that tells us whether those internal controls were operating effectively or not. So just remember there may be times where a sub-to-procedure alone would not be sufficient.

And so therefore, for example, if we went back to our seesaw diagram a little bit earlier in slide number six, if I can't get substantive evidence that's going to be enough for me, I have to rely on the internal controls. And if I can't rely on the internal controls, meaning I tested them, then I might have a scope limitation, right? I may not be able to opine on that particular item.

So, a lot of times when standards indicate test of controls will be required might be when there's a lot of electronic evidence, when certain types of fraud risk, when the completeness assertion is at risk, there's certain times of significant risk, or we're using one of those service organizations, like I mentioned just a few minutes ago. All right.

I'm going to go ahead and move forward with our discussion on the substantive test side of things. Now, as we saw a little bit earlier, this is where we're designing those work programs to respond to those risks of material misstatement, those ROMMs, the IRs times the CRs.

We're passing these through our detection risk procedures, which again are our work programs themselves. The nature, the timing, and the extent of all the procedures that we feel are going to give us the evidence that we need to be able to, again, opine that this particular assertion is free of material misstatement. Now we're told by the standards, be really careful when you're using some of these more generic work programs.

Because again, a lot of times those are not appropriate responses because the risks vary between entities. So, they're saying, please, auditors, use your professional judgment to appropriately choose the procedures that you believe you need, given the risk.

Treat that accounts receivable work program as a database of all the different procedures that you could choose from related to accounts receivable. That means you don't have to perform all of those different procedures.

You can add to those procedures, you can delete from those procedures, you can customize those procedures. Remember, you're the auditor, you're the one that ultimately is going to be opining. So, you get to pick and choose the types of evidence that you want and the ways that you're going to go about gathering that evidence.

Now, as we saw a little bit earlier, then when we talk about substantive procedures, we're talking about the nature, which means what kind of procedure are we performing, i.e., maybe that is going to be a confirmation. We're going to be talking about the reliability of the evidence. Are we able to get sufficiently complete and accurate information? Can we get it internally versus do I need to get it externally? When do we want to proceed to perform those procedures. So, the proximity to the balance sheet or the transaction date. And then how many.

So, we talked a little bit earlier about the precision or the scope of the procedures or our sample sizes, depending on the methodology that we have just chosen to choose those particular items for those tests.

So, let's talk about how we then design those substance procedures. The first place I want to start then is going to be those analytical procedures. Now analytical procedures are required by the auditing standards as preliminary analytics. So in our planning process, as a risk assessment procedure, just know that these are required by GAAS, preliminary analytics.

These down here as substantive analytics are not required by GAAS. I'll put a little X there. Now I think that you should perform substantive analytics. Because I think that they're very, very effective and they help make you a smarter auditor. But you're not required to do so. But you are required to perform the final analytic at the end of the engagement, that final review, for example, by the partner or the concurring partner or the technical review partner.

So, preliminary analytics and final analytics are required by gas. Substantive analytics are optional. Okay, I'll put OPT here so that you know that they're optional. All right, so let's talk a little bit more about our analytics. Remember, this is just one of the pathways that we can choose when we're designing these substantive procedures. Now, substantive analytics, as you see here on the slide.

They're primarily used in low-risk areas. If they're used in a high-risk area, they need to be really strong analytical procedures. Which means they need to be linked to the relevant assertion. Are they testing the assertion or the assertions that you're concerned about? So, for example, a little bit earlier, I used the AR turnover ratio. With the AR turnover ratio.

Pretty much gives us evidence about the existence assertion of accounts receivable. It's going to give us limited evidence about, let's say, completeness, which is the understatement assertion. It might give us a little bit. It might help us a little bit with the cutoff assertion, but it's not going to help us at all, let's say, with the valuation assertion. So again, it needs to be linked to the assertion or the assertions that you're looking to gather evidence about.

It has to be based on reliability. So, am I able to get reliable information in order to form my expectation? I need to think about how strong or how precise that expectation is going to be. And I need to be able to think through how far of a difference or how big of a difference am I willing to tolerate from my expectation? So, I need to have a really powerful client expectation explanation.

For any of the larger differences between my number and the clients. So, let's say, for example, that we were doing that AR turnover ratio example a little bit earlier. And let's say that I expected, okay, in my analytic that the AR balance would be about \$100,000. And so, I go look and the client has that \$95,000 in their general ledger. And I may go, wow, it's right on target. I feel really good about it. We're good but instead of \$95,000, let's say that they have 300,000 and their accounts receivable. And I'm like, whoa, that is way off from my expectation. What the heck is going on here?

Now that doesn't mean that there's an error or there's fraud. It just means, Chris, go out there and get an explanation from your client. Maybe they have a really good explanation as to why their balance is \$300,000 versus my expectation of \$100,000.

Let's say, for example, they go, hey, Chris, we had this one really large sale here in the last month of the period from one of our larger customers. They ordered a significant amount of product from us. And I go, okay, great. That's wonderful. Can you please validate for me that for me? Can I see the sales order for that? Let me see the shipping documents related to it. Let me see the invoice. Maybe I'm even going to confirm that transaction with that particular customer. Right.

And if I were to then remove that one transaction, maybe my expectation then falls back in alignment with what the client has recorded. If the client doesn't have a good expectation or a good explanation, I should say, then I'm going to have to probably test the heck out of it with test of details. Maybe I'm going to confirm a whole lot more because this number that they have recorded is so far away from my expectation.

So again, what is the acceptable difference from the expectation? And how are you then going to follow up on that explanation from the client? Now remember, just like everything else, when you're documenting your analytical procedures, it has to be re-performable. So, you would need to document what your expectation is, the basis for that expectation, your threshold for variance, and then how you responded to that particular variance.

As a peer reviewer or as a reviewer of your file, I need to be able to reperform your work with the assistance of your client. If I so chose to do so. So, what's the big deal about analytical procedures? Again, they can be very powerful, but they do require you to have a good understanding of your client's business, a good understanding of your client's transactions.

You have to have a really good handle on what the risks of material misstatement are going to be. You have to think about the types of evidence that you're gathered and there's a lot of professional judgment that's involved. The standards tell us, hey, auditors, when you do these well, they can be more effective and efficient than detailed testing.

So, the standards say we love analytical procedures, but if you want to use them, do them the right way. When done poorly, they often fail to achieve those audit objectives. So just be really careful.

When we're determining our expectation, remembering, by the way, that an analytical procedure just simply is the auditor develops an expectation about what he or she thinks that number should be based on their knowledge of the client and the industry, et cetera. And then you compare your number to the client's number. And if you're close, maybe that's all you need.

But if you're not really close, you need to do a little bit of a follow-up on that. You can strengthen that analytic, you can get explanations from the client, et cetera. So when you're determining your expectation, which is step one, you can use things like a prior period comparison.

Maybe you could use a budget or a forecast. It might be a relationship among financial statement items, like those ratios, like that, our turnover ratio that we talked about a little bit earlier. It could be non-financial data like the number of customers, the number of contracts, the number of employees, locations, et cetera.

Industry information or other comparable information. It could be current economic trends, it could be current your client activities. All of this information can be useful to you in forming a really solid expectation. If you can come up with a really good expectation, then that means that this particular area is a good candidate.

For analytical test work. Then you just need to determine: well, how strong does that evidence need to be? How strong does this subset analytic need to be?

So, this particular slide, this is one of my colleagues put this one together, and I thought it was kind of an interesting slide. It says if the risk is the risk of you falling asleep during today's presentation and if you have a significant risk of being bored and falling asleep on me, then you might need a giant coffee from Starbucks. I think these are the Starbucks names, the various sizes of their coffees. But hey, you're, you know, you've had a good night's sleep, you're kind of excited about this particular topic, you're learning a lot. Okay, then maybe you need a smaller size cup of coffee. So therefore less caffeine to keep yourself awake.

So that's what we're also thinking about when we think about these analytics. How risky is it? And the riskier it is, the stronger the cup of coffee you actually need, or the more you're actually going to need. So, a way to strengthen it is to increase the precision, the accuracy level. The accuracy could be based on the type of analytic.

So, for example, the weakest kind of analytic is a simple trend analysis, trend over the last several years, for example. Going up in strength, a ratio is stronger than a trend. A predictive is stronger than a ratio. A regression analysis is the strongest type of an analytic that happens to be out there. So, this is strength going up. Or as we progress down this particular list. The level of disaggregation can also increase your precision.

So instead of, for example, looking at sales this year compared to sales last year, maybe I'm looking at sales by product line or sales by location or sales by salesperson, for example, compared to a previous period. So that level of disaggregation can help you be better, okay, or more precise at identifying areas where there might be an error or fraud, something that you need to look into just a little bit.

So, for example, if we were using a trend analytic, remember which we said was one of the lowest types, that trend analysis might be perfect for a low risk area, but it's not going to be for a more moderate, okay, or a high or a significant. It's only giving us this much evidence.

So, I'm going to have to fill up, for example, the rest of this with either a stronger analytic or other analytics or with test of controls or with other tests of details. I think it was a pretty interesting illustration. A predictive analytic might be too strong. So you see the overflow here for the lower risk areas. It might be perfect for a moderate, but it's not enough for a high, and it's not enough for a significant. So in this particular case, again, you would need to fill this cup up with other analytics, with stronger analytics, or with other test of details, or with test of controls.

Again, remember, this is all going to be up to your professional judgment. Another way to strengthen your analytic is to provide corroboration. So, get information from the controller is a good place to start. But if you can get information outside of the controller or outside of the accounting department or outside the company, oftentimes that's stronger and stronger types of evidence.

Also, if you happen to be doing inspections, looking at original documentation rather than copies or faxes or emails, for example, can be stronger than getting something from the controller that happened to be a photocopy. If you can get it externally, it's even stronger. So again, it's just thinking about the sources of the information that you happen to be using.

In not only your analytics, but in any test that you have to be performing. So, strengthening it by corroborating. Now these are summarized in this particular table, which again, I think is a great tool. So, this is one that if you have this printed out or if you happen to be taking notes, put a star by this one because this is a very powerful slide to help you get really good at your analytical procedures.

Okay, whether it happens to be a preliminary analytic or a substantive analytic, or maybe even your final analytic. And the way that we go about doing it is pick your analytic. Is this particular item comparable? Comparable to a prior period or other accounts or budgets or non-financial data or other companies. If it's not comparable, is it predictable? Can you identify the significant factors that impact the balance? If you can do this or this, then this is a good candidate for analytical procedures.

Now, once I've said, hey, this is a good candidate, and here's how I'm going to go about performing that particular analytic, how strong do I need it to be? That strength is based on things like materiality, the risk of material misstatement. Am I performing other procedures on this? Did I perform test of controls, for example? if we were doing a council receivable existence, do I know, for example, I'm also going to be doing confirmations? And because I'm doing a confirmation, I don't need a really super-duper strong analytic because I'm not relying only on the analytic.

And again, just like we talked about earlier with test of controls, what are the cost benefits of doing the analytic over the alternative test of details? Okay, again, you want to make sure that it has a cost benefit to you. As we saw on those last couple of slides, to make it stronger, you can add some corroboration, you can increase the precision. And then finally, once you've determined the strength and you believe that you have a really powerful way of testing this with analytics, you execute it, you assess your results.

Remember, if additional evidence is necessary, okay, you can go back to the beginning, you can repick your analytic, you could strengthen that analytic, okay, again, by adding corroboration and precision, or you can say, hey, you know what, I'm just going to change to test of details or test of controls and gather other evidence outside of the analytic itself.

Now, the last one here, just remember to consider the impact, for example, on other GL accounts. So, let's say, for example, we know that we hired 20 new salespeople. And so, I'm testing revenues and accounts receivable. And I go up, there's 20 new salespeople. I might expect sales and accounts receivable to go up by those 20 additional efforts of these new people.

But okay, because there's 20 new salespeople, hey, maybe plant property and equipment needs to go up because I have new computers that we need to buy for those 20 new salespeople. Maybe we need to rent additional office space for them. So, it could have impact on other General Ledger accounts as well. So, they're just saying use that information as expectations to help you test other areas besides the area that, again, you might be testing directly with those analytics.

Now, this is just a reminder that these are those APICPA publications here on analytics. So, you can go out and take a look at those. And as you're documenting your analytics, we have AU-C 230. AU-C 230 is going to be the audit standard that deals with documentation. And AU-C 520 is the audit standard that deals with analytical procedures. So, you'll want to look at both of those.

They're not very long. They're not overly difficult to read or understand. So, I really encourage you to check out these particular auditing standards. They also deal with the documentation requirements for your analytics.

Remember, it just simply has to be re-performable by an experienced auditor that has no connection to the engagement. So, they need to be able to understand the expectation, the source of your expectation, the variance from the actual balances and what you decided to do about it, and ultimately your conclusion about whether that was enough evidence or not.

Yeah, this next slide, similar to the one that we saw a little bit earlier on test of controls, is a pretty good summarization of what kind of information you would need to gather. So, for example, if we were doing that AR turnover ratio that we talked about a little bit earlier, okay, what kind of data are you using to test it? Okay, so maybe in this particular case, we're using the sales reports, for example, right?

How reliable are those? Were there any internal controls over sales, for example, to make sure that that information was reliable? What was your expectation? What level of precision did you need? What's your threshold for variance? How did you investigate that particular variance? What was your level of assurance that you ultimately obtained from that? And then here's your workpaper reference to where you actually did the work.

Now let's change over and talk a little bit more about designing test of details and transactions. And remember, we talked about scope and judgmental selection. So if I put up that expanded seesaw diagram that we looked at a little bit earlier, this is where we are. We're now talking about these test of details. And remember, as we decide that we're going to be testing details, so obviously, this is either a GAAS-required area, okay, like confirmations, for example.

Or it's an area where we feel like we weren't able to get enough evidence with internal controls and we were not necessarily satisfied with the additional evidence that we gathered through analytical procedures. So, we believe that we also need to test some details. As we are then choosing items to test the details of, remember, I can choose them judgmentally, I can use a scope, or I can use samples.

So, I want to focus a little bit on the sampling aspect of these because this is an area where oftentimes we see a lot of peer-reviewed deficiency comments and we notice a lot of inefficiencies from a sampling aspect.

Now, when it comes to choosing the items for your test of details, only two options exist. It's either sampling or it's what we call 100% testing. And you're like, wait, wait, Chris, what do you mean 100% testing? We have to test 100%. And the answer is yes, but it may be not be exactly what you're thinking of. Now, if I go back to that seesaw diagram, notice I've got 100% here and I've got sampling here.

So, when I say 100% testing, and let's say that we're using scopes to choose accounts receivable confirmation for confirmations. So, we have the AR subsidiary ledger. Well, if I chose every customer balance greater than \$10,000, okay, let's say that I were to add all of those up and it came up to \$200,000 worth of accounts receivable, but their AR subsidiary ledger adds up to a million.

That means that I have \$800,000 out there that's not tested. So, I compare this untested portion to my performance materiality. Okay, let's say performance materiality is \$75,000. And I know that I'm not finished with that particular area because I'm only testing, you know, a small portion of that.

Okay, I've got \$800,000 untested. Well, what do I do with that, well, I can't just leave that untested. I either have to go back and perform analytics on it, or I have to perform some test of controls on that area, or I have to change that scope so that I have an immaterial untested portion, right? Or I have to do sampling on that untested portion. So, I've got three different choices. I can change my scope.

I can sample, I can do analytics, or I can do internal controls on it. That's how I'm achieving this 100% coverage. So that's what they mean here by only two options exist. So it could be, for example, scope testing with tested controls and or analytical procedures on the untested or the whole population, or maybe a judgmental selection of some items.

Again, with tested controls and our analytical procedures on the untested or the whole population that we talked about a little bit earlier. And graphically, it might look like this. If we were using scope testing, for example, I could use any level for my scopes. Here's my untested portion. What's the dollar magnitude of it? If it's greater than performance materiality, I've got to do more work by adding additional items for my scopes or do internal controls work or analytics on either just this portion or on the entire population itself?

Now, some common non-sampling areas, Fixed asset additions, accounts payable, search, okay, the outstanding check testing, prepaids, other assets, those areas typically lend themselves very well to things like scope testing or judgmental selection. Okay, why? Well, because usually those populations are not usually very, very large, right? And it's not what we call a relatively homogeneous population.

So, for example, if I was doing a search for unrecorded liabilities by looking at subsequent cash disbursements, the further and further that I get away from year end, the risk of a check relating back to year end may be decreasing. So therefore, my scopes should be going up.

Now, when is enough enough?

Okay, just remember, just like anything else, this is professional judgment driven. So, you're thinking about materiality, you're thinking about the risk, and you're thinking about how much reliance you're placing on those particular areas.

Okay, so when we start talking about the extent of your substantive procedures, okay, remember we're talking about individually significant items. Those are those scopes that we were talking about just a moment ago. And your scopes could be things like: hey, this is over a certain dollar amount, or this is something that is unusual. Okay, we're going to be comparing that to that tolerable misstatement.

And I'm going to put up here performance materiality.

Okay, which essentially these are the same things. We call it performance materiality when we're talking about a non-sampling area. We're talking tolerable misstatement when we're talking about sampling. And it's just using the correct terminology depending on the methodology that you're using to select the items for testing.

So, if you're using sampling, we're using the phrase tolerable misstatement. If we're using scopes or judgmental selections, we're referring back to performance materiality. And again, just like we saw in those diagrams just a moment ago.

We're talking about items that would give us enough of that coverage. Is the coverage adequate? Do we have a material non-tested portion? So that remaining balance is the untested portion. And we would do no further testing if the risk on it is low. Otherwise, we apply those analytical procedures or we perform other substantive procedures on that untested portion.

For example, we could then, as I just discussed, sample or change the scopes or we can stratify the sample. I'm going to get into all of these various items here in the next couple of minutes. So, let's talk about sampling first.

Now remember we saw sampling a little bit earlier called attribute sampling when we're using test of controls. Now we're talking about variable sampling. Now this is the type of sampling that we use for subset testing. Why? Well, remember for attribute sampling, it was a yes or no. Did it pass or not? Here we're trying to determine the magnitude of a misstatement.

So, this is going to help us get to a dollar error. This remember, yes or no. This is the dollars. So variable sampling used in substantive test of details. Common sampling areas. Remember larger populations that are relatively homogeneous in nature, accounts receivable, inventory, loans, many, many other types of areas lend themselves very, very well to sampling.

Now when we decide that sampling is going to be the appropriate way to select items for tested details.

Just like we saw with test of controls, we have to define our population. So, if I'm doing confirmations, for example, my population would be the accounts receivable subsidiary ledger. We also then define the sampling unit. Well, what do you want to be sampling within that accounts receivable subsidiary ledger? And you may want to say, hey, I'm going to sample customer balances.

You may say, Well, I don't really want to sample customer balances. I would rather sample individual invoices that are within that accounts receivable subsidiary ledger. So, you get to use your professional judgment to determine the appropriate sampling unit. Once you've done that, you've defined the population, you've defined your sampling unit, then you determine your sample size. How many items do I have within that particular population?

Now obviously if we use customer balances as the sampling unit, we're going to have a smaller population size than we would if we were to choose individual invoices within the accounts receivable subsidiary ledger. So, it really does depend on the items that you have defined as your sampling unit. So, once you've determined that sample size, you simply choose the method of selecting those items that would be representative of the population. Now, what do we mean by that? Well, that would be haphazard, right?

It would be systematic or it would be random. All of those are going to be valid ways of choosing various items. You're then going to go and choose these items from that population. You're going to test them, and then you evaluate the results. And then you are able to then extrapolate or project that particular error rate to the overall population.

So, for example, in determining that sample size, here are the eight steps that you go through with determining the sample size. You have to know what your tolerable misstatement is going to be. You assess the risk.

Okay, are we dealing with a high, medium, or low risk of material misstatement? We look to see, hey, am I doing other procedures on this? So, for example, did I test controls over this area? Did I do a substantive analytic on this area? If I did, then your other substantive procedures provided evidence for you. So, you're not making the sample do all the work. So therefore, you get to use a lower sample size.

But if sampling is the only way that you're gathering evidence, that means that you're relying only on your sampling techniques. So therefore, your sample sizes are going to be higher. If you go to the AI CPA audit guide to sampling, it's going to walk you through this subset of procedures risk, and it's a factor that helps you determine your sample sizes.

Okay, so you determine that risk factor, you determine that remaining population, you estimate your expected misstatement, and then it walks you through a calculation of your sample size. Hey, Chris, given all of these items, you need to confirm 30 accounts receivable, for example. Then you would adjust your sample size if you chose not to stratify that population. And stratification is a technique that we use within audit sampling.

To divide a particular population into what we call strata, into like areas. And if you stratify, that means that you get to have a lower sample size because you are actually lowering what we call sampling risk. The risk that you chose items that were not representative of the overall population. And stratification sounds like a really technical word, and it is.

But it's not as difficult as you might imagine, right? And I've actually got a couple of slides here that talk through stratification and give you a few examples of how you might stratify. So again, these are some of those bonus slides. Here's how you go about assessing that tolerable misstatement. Here's one of those tables that we were looking at a little bit earlier. If your IR, for example, is high, but you came down to a low control risk, we're only dealing with a moderate risk of material mistake.

So, you'd use tables similar to this to help you determine that risk of material misstatement. That other substance procedures, substantive procedures risk, remember, is the risk that other substantive procedures might fail to detect a material misstatement. So how much effort, how much evidence, how much reliance are you placing on this one particular procedure?

If, for example, you're doing a lot of other procedures, your other substantive procedures risk is lower. If this is all you're doing, your other substantive procedures risk is going to be higher. And again, all of those other producers of that information give you tables similar to this one that help you determine what that risk factor multiplier would be that enters into your calculation of your sample size.

Then you determine the remaining population. Once you've pulled out, for example, all of your individually significant items and any other items that you would have considered significant. So, for example, they were unusual, then you have that remaining population. That is the population that you're going to be sampling from. Notice you've got a little, real quick, efficient approach here for helping you determine what that ISI would be given the risk factors from this previous table that we looked at just a moment ago.

Then you did determine, as we saw in that one checklist, what is your expected misstatement in that particular area? That's again going to factor into your sample size. So, you take your sample population, divide it by tolerable misstatement, multiply it by the risk factor from that table that we just saw, and that's going to give you your sample size.

Stratification, notice the little picture here where they've got these noodles that are divided into separate strata. So, we've got some, you know, Rotini, we've got some penne over here. I don't know what you call that kind of pasta over here. We've got some other kind of pasta.

So, we've segregated them into like categories. And because we're doing this, okay, we have a less variability factor in each one of those particular groups. And so therefore the sampling risk is considered to be lower. And so therefore you get to get a lower sample size.

Here's an example of a common way to actually stratify. If you don't stratify, there is a consequence. You have to increase your sample size anywhere from 20% or actually from 10% to 100%, and 20% increase is the most common in practice.

Common issues when we're sampling. Hey, there were items that couldn't be tested as planned, or we had unused or voided items or isolated areas, not areas, errors. Anytime we have any of those particular items, we have to factor those particular items in. Let's say, for example, there was a voided item. Well, maybe I've chosen additional items from the population that I can replace if I have one of those voided items. If I had an unused item, again, I can replace it by one of the additional items that I chose from my sample.

The projection of the misstatement, then, this is oftentimes called the extrapolation. And there are two different methods that you can use. The ratio method is the most common method.

Both of these are useful in practice. Okay, and either one of them is acceptable. If you have multiple strata, then okay, so for example, we had one, two, three, four strata, you extrapolate the error from each strata, and then you add each one of those together to get the projected misstatement for the entire population.

Netting misstatements, anytime we have misstatements in there, remember those could be overstatement or understatement. And it's okay to net those particular items. But just note, if overstatements or understatements projected separately would be greater than tolerable misstatement, that means that there's a greater risk of undetected material misstatement. So, you just want to be aware of that and have this conversation within your engagement team to determine whether or not you need to expand that test work.

Or you're okay with the results. Auditor judgment is going to be required here. Oftentimes we can also use what we call dual purpose tests. And a dual-purpose test, okay, very, very common, and you want to use these whenever you can. It is a substantive test and a controls test together. If you decide to use a dual-purpose test, just note here that the sample size is the larger of the samples.

So, you would determine your sample size for your test of controls. You would determine your sample size using the technique that we just talked about for your substantive test work, and you use the larger of those two. And then any deviations would be evaluated separately.

And so, as I wrap up today, I just wanted to bring us back really quickly to the one central theme. Remember, effective and efficient audits don't come from doing more work.

They come from doing the right work in the right areas and for the right reasons. So everything we discussed today, testing controls, designing subset procedures, sampling, stratification, dual purpose test, all of those flow from solid risk assessment and clear professional judgment. When all of those are aligned, audits are not only more defensible, they're also more efficient and easier to explain to reviewers, regulators, and our clients whenever necessary.

So, my hope is that you walk away today with a few practical takeaways that you can apply immediately, whether that's being more intentional about when you test controls, more thoughtful in how you come up with your sample sizes, or being more deliberate in how you document your decisions. So, thank you so much for your time today and the work that you do as professionals.

And I hope today's discussion helps make your future audits a little smoother and more efficient.



Webinar

Best Practices for Effective & Efficient Auditing: Planning and Risk Assessment

Presented by [Christopher K. Martin, CPA](#)

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Christopher K. Martin, CPA

Chris has worked with CeriFi CPEdge since 2003. His public accounting career has included such positions as Senior Manager at Andersen, where he also served as a regular faculty member at its Worldwide Centre for Professional Education, and as CFO for an SEC-registered communications company based in Atlanta.

In addition to his instructor activities, he works as a financial, management, accounting and education practitioner/consultant serving clients throughout the US and internationally in Bermuda and India.

He received his finance and accounting education at The Florida State University.



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Learning Objectives

Upon completion of this webinar, participants should be able to—

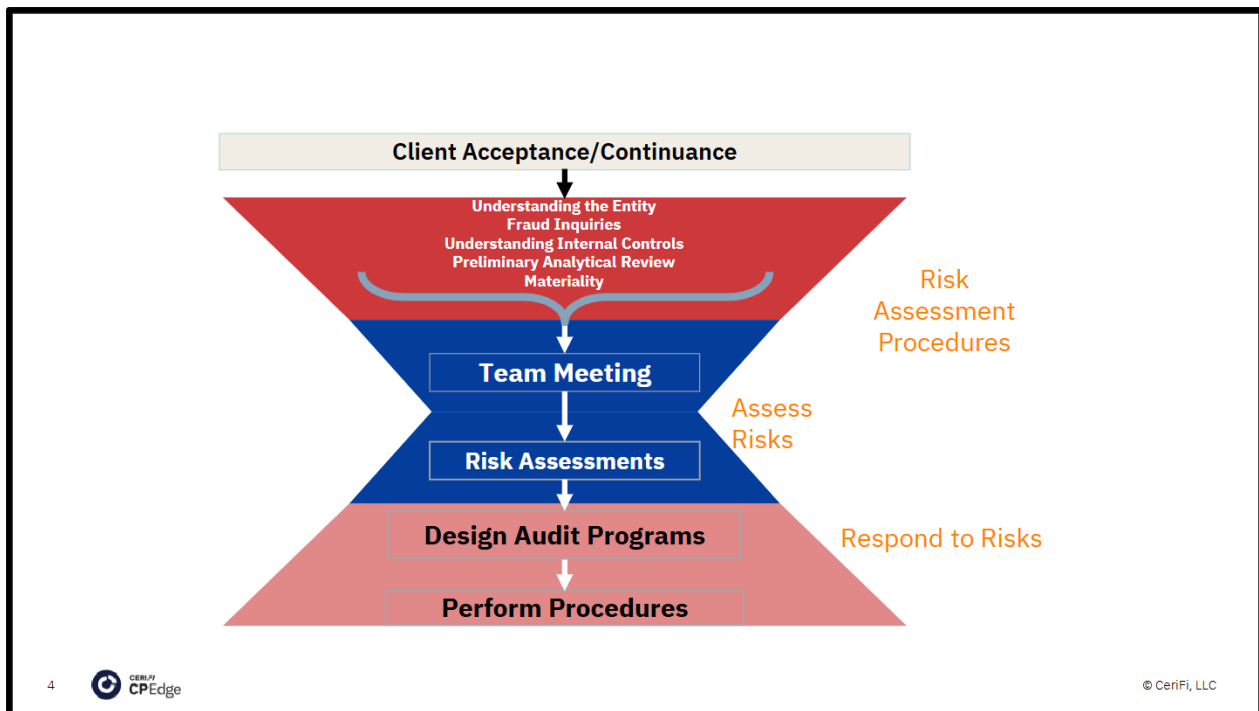
- Describe an in-depth knowledge of the entity and its environment
- Identify appropriate risk assessment procedures
- Develop an overall audit strategy
- Document risk assessment and planning procedures

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Planning Materiality and Scopes

- Planning materiality
- Tolerable misstatement/Performance materiality
- Lower level of materiality for particular items
- Clearly trivial misstatements
- **ALL ARE RISK BASED**



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Financial Statement Materiality

- **Basis for selection** of a benchmark and related percentages
 - Total revenue 0.5%–2.0%
 - Total assets 0.5%–2.0%
 - Gross profit 1.0%–2.0%
 - Pretax income 5.0%–10.0%
 - Equity 1.0%–5.0%
 - Cash flows from operations 3.0%–5.0%
- Calculation of **planning materiality**
- Lower level of planning materiality for particular items
- Trivial misstatements
- Changes in materiality amounts



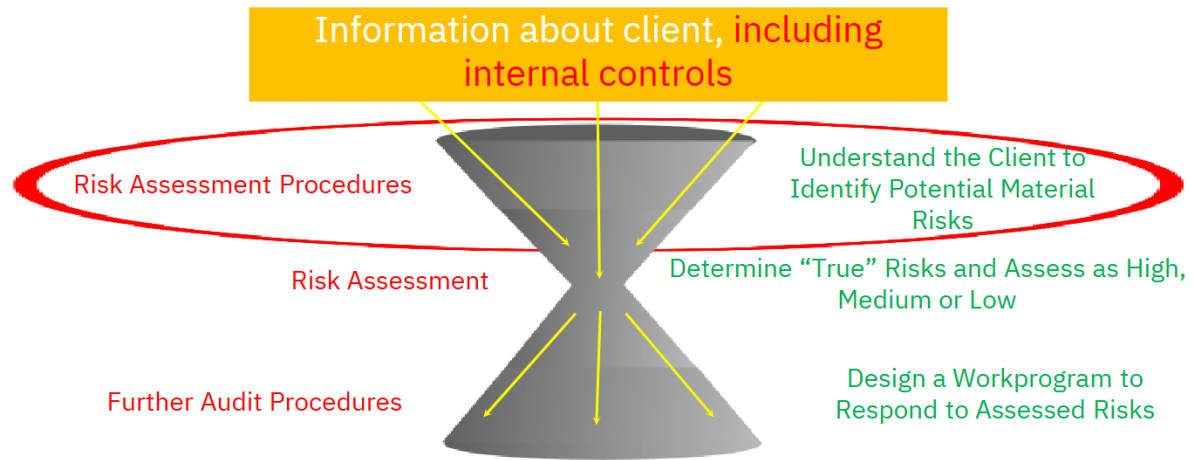
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The Audit Plan



Each component of the Audit Plan must be clearly documented in the workpapers!

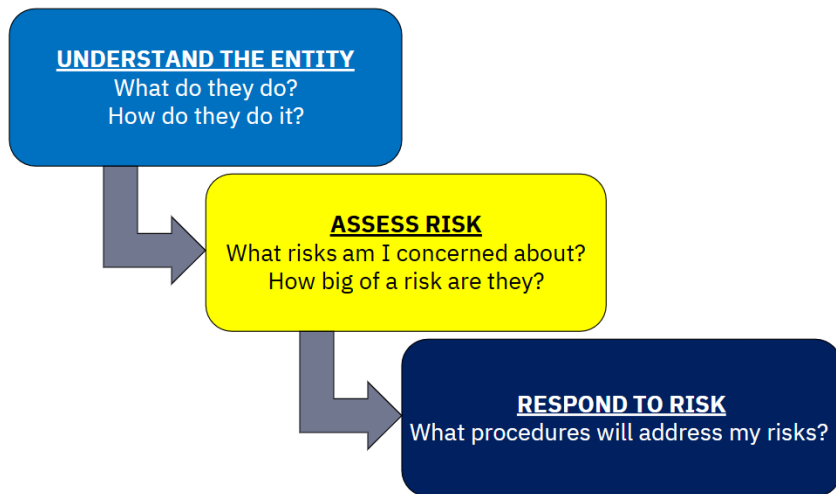
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Risk-based Audit



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Auditing the Wrong Way

- Complete one form
- Complete another form
- When all the forms are done...
- You're done!



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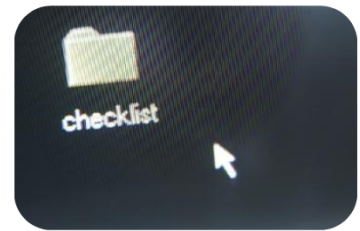


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Forms and Checklists

- Should be used for Documenting:
 - Procedures you performed
 - **Conclusions** you reached
- Should not be used to:
 - Drive your procedures
 - Make your audit inefficient
- They **are not** audit documentation (which includes the **basis** for the conclusions)



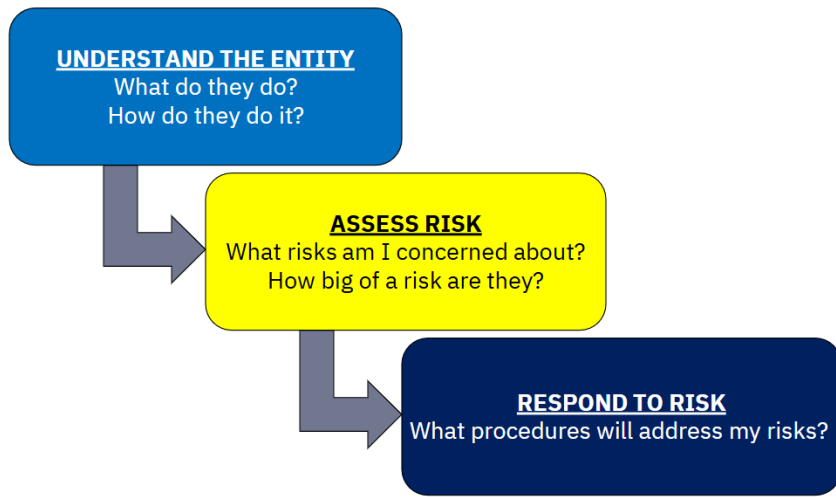
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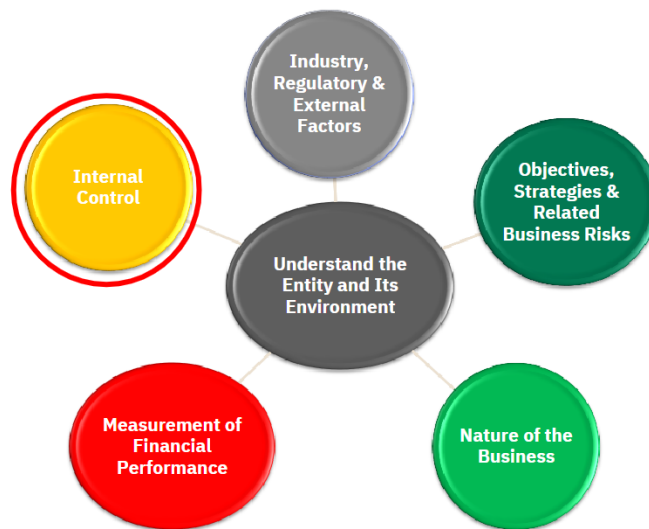
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Understanding the Entity



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Understanding the Entity – Best Practices

- Make responses robust and complete
- Focus on changes
- Evidence includes more than just inquiry alone:
 - Observation,
 - Inspection,
 - Reperformance,
 - Analytics
- Document risks as they arise
- Use cross-referencing



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Understanding the Entity – Best Practices

- Make responses robust and complete
- Did this answer help me:
 - Identify risk or identify that there is no risk?
 - Get enough info to determine how risky it is?
 - Get enough info to design substantive procedures?



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Common Responses

- Understanding the entity questions:

Describe the nature of the entity's major assets and liabilities.

“Cash, A/R, Inventory...”

-OR-

“See financial statements”



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What if Instead....

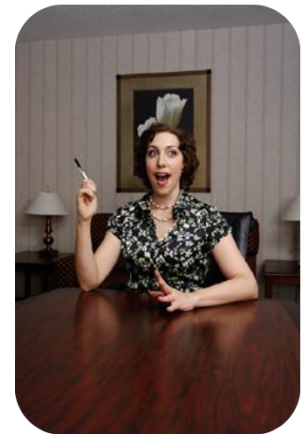
Information:

Accounts receivable are comprised of:

- A large number of small customers
- A small number of large customers

Risks/Procedures:

- Lower risk in allowance, sample confirmations and analytic of allowance
- Higher risk in allowance, scope confirmations and scope allowance testing



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Focus on Changes

- *Typical:*
 - The majority of the client's A/R is from the federal government.
- *What if:*
 - As of 12/31/PY, \$4 million of the \$4.2 million in A/R was from the federal government. As of 12/31/CY, \$3 million of the \$4.5 million in A/R was from the federal government.



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What Could Go Wrong Analysis

Risk assessment process

- Understanding the entity: facts and circumstances
- Yield a litany of risk factors
- Translate into “what could go wrong”
- Determine the effect
 - Audit area
 - Assertion
 - Direction
 - Magnitude



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Don't Be Afraid to Identify Risks!!



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Understanding the Entity and Identifying Risks

Topic	Facts and Circumstances	Risk Factors	What Could Go Wrong	Effect (Audit area, assertions, direction, magnitude)
Entity information • Users • Stakeholders • Key personnel • TCWG • Audit committee • Related parties				
External factors • Industry • Regulation • Economics				
Nature of the entity • Business ops • Investments • Financing • Acctg principles • Going concern				

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Understanding the Entity and Identifying Risks

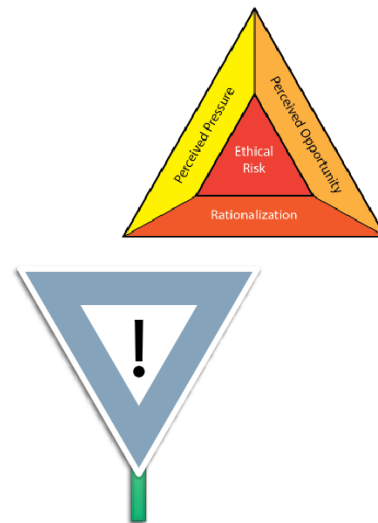
Topic	Facts and Circumstances	Risk Factors	What Could Go Wrong	Effect (Audit area, assertions, direction, magnitude)
Business strategies and related risks				
Financial performance				
Fraud risk				
Noncompliance with LRCA				
Describe the sources of information used and procedures performed to obtain or update your understanding of the entity and its environment.				

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Consideration of Fraud

Fraud risk assessment process

- Identify potential fraud schemes and scams
- Make inquiries of management
- Evaluate unusual or unexpected relationships
- Evaluate the entity's antifraud programs and internal controls
- Include in the engagement team discussions



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Fraud Inquiries

Inquiries of management, those charged with governance, and other employees

- Knowledge of any actual, suspected, or alleged fraud
- Process for identifying, responding to, and monitoring the risks of fraud
- Nature, extent, and frequency of management's assessment of fraud risk and the results of those assessments
- Specific risks of fraud that management has identified or that have been brought to its attention
- Classes of transactions, account balances, or disclosures for which a fraud risk is likely to exist
- Management's communications, if any, to:
 - Those charged with governance on its process for identifying and responding to fraud risks
 - Employees on its views on appropriate business practices and ethical behavior
- Significant unusual transactions: the nature, terms, and business purpose (or lack thereof); and whether such transactions involved related parties.

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Consideration of Laws and Regulations

Risk assessment process

- Identify those laws and regulations that directly determine reported amounts and disclosures
- Evaluate internal controls (policies and procedures) adopted to prevent noncompliance
- Review prior history of compliance with laws, regulations, contract provisions, and grant provisions
- Determine the effects of noncompliance such as fines, litigation, inspect correspondence with relevant regulators, and include in legal inquiries



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Auditing Accounting Estimates

SAS No. 135

- Understand GAAP accounting and disclosure requirements
- Risk assessment process
 - How management identifies transactions, events and conditions that give risk to new accounting estimates
 - How management makes accounting estimates and the data on which the estimates are based
 - Retrospective review of accounting estimates made for prior period financial statements or subsequent re-estimation for the current period

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Related Parties

SAS No. 135

- Include in engagement team discussion
- Inquiries of management: parties, relationships, transactions, business purpose
- Risk assessment
 - Significant related party relationships and transactions
 - Internal controls over related party transactions
 - Exceptions to authorized and approved transactions
 - Discussions with those charged with governance
 - Include in fraud risk assessment



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Understanding the Entity and Identifying Risks – Understanding Internal Controls



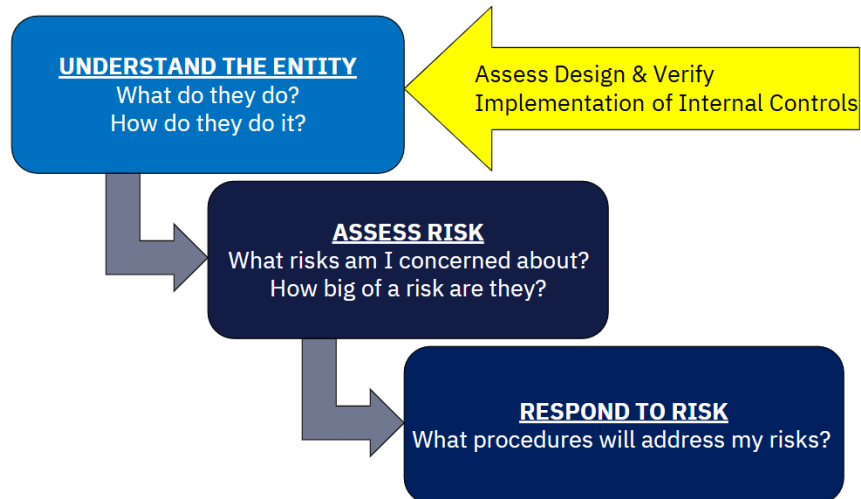
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Risk-based Audit



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“Understand” Internal Controls

What is the objective of “understanding” internal controls?

- Identify and assess risks in order to....
- Design further audit procedures

“Understanding” encompasses two procedures:

- Evaluating the design effectiveness of controls for significant classes of transactions
- Determining whether the properly-designed key controls have been implemented (placed into operation)



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Evaluating Design

Control Objective: Only valid orders are fulfilled

Risk: Orders are created for fictitious customers

Control: Orders can only be issued for customers on the approved list. All new customers must be approved by department supervisors and the approved customer list is reviewed regularly.

Risk: Duplicate orders are processed

Control: The order system assigns unique, sequential order numbers for each order.

Risk: Orders are processed at unauthorized prices or terms

Control: All sales orders are approved by a department supervisor.

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Top-Down Approach

An entity may have hundreds of controls in place!

- Focus on controls related to financial reporting
- Identify the significant classes of transactions
- Identify the most important risks in each class of transactions (What Can Go Wrong)
- Identify the most effective controls related to those risks (Risk of Failure of Key Controls)

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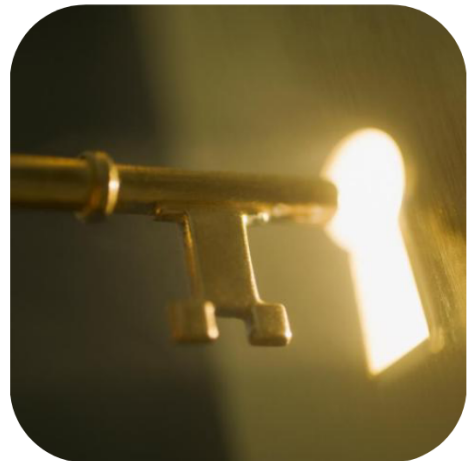
Focus on Key Controls

Important activity-level controls

- Authorization
- Segregation of duties
- Documentation
- Safeguarding of assets
- Reconciliations

Entity-level controls

- Management reviews
- IT security



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Verifying Implementation

Implementation IS—

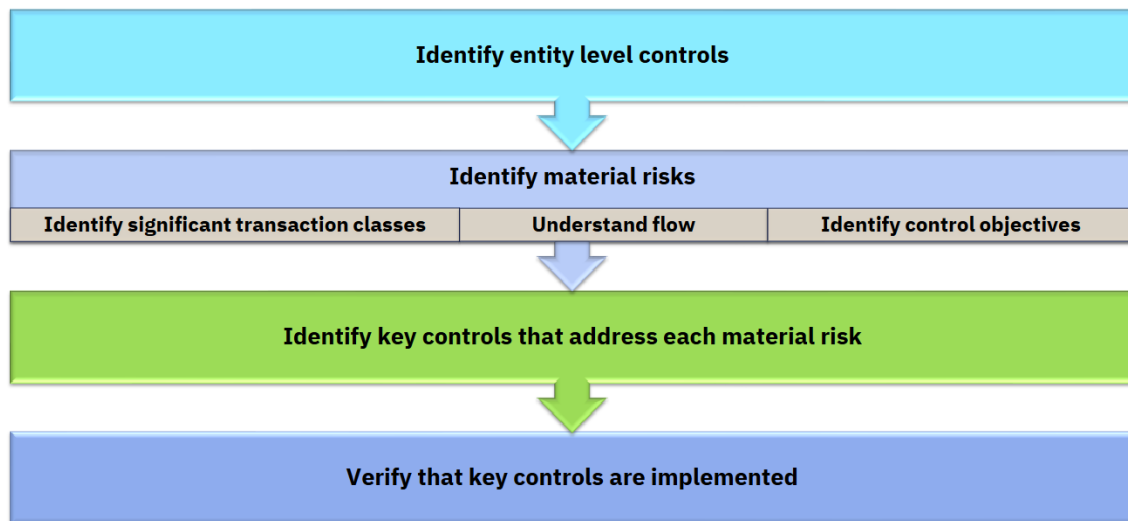
- Corroborating what the client told you about controls
- A test of how many?
- A combination of inquiry, observation and inspection
- Controls focused

Implementation IS NOT—

- Sufficient evidence to rely on controls (in most cases)
- Based only on inquiry
- A “tick and tie” exercise
- A confirmation of the process—need to focus on controls!

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Top-down, Risk-based Approach



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Understanding Entity-level Controls

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Entity-level Controls – Best Practices

- Focus on the key controls
- Make controls client-specific
- Ensure key controls are implemented



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Key Controls

- Not required to understand ALL controls, so...
- Focus on those controls that are most important in achieving the control objectives



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Adding Client Specifics

Before:

- Management sets realistic financial targets and expectations.

After:

- In September, department heads are required to submit a budget for their department to the CEO and CFO. CEO and CFO review the budgets, considering their knowledge of the business and the company's overall goals. Any questions or issues are discussed with the department heads before final approval of the budgets. Budgets-to-actual are then reviewed on a monthly basis by CEO, CFO and department heads during monthly management meetings.

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Required Control Documentation

WHO

- Who performs the control?
- Is the right person performing the control?

WHAT

- What source documents are used to perform the control?
- Is the control being performed according to established policies and procedures?

WHEN

- How often is the control performed?
- Is the control being performed consistently?

HOW

- How do they document performance?
- Could the control be overridden by management?

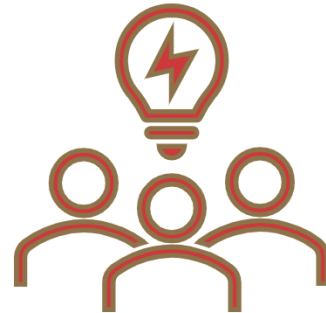
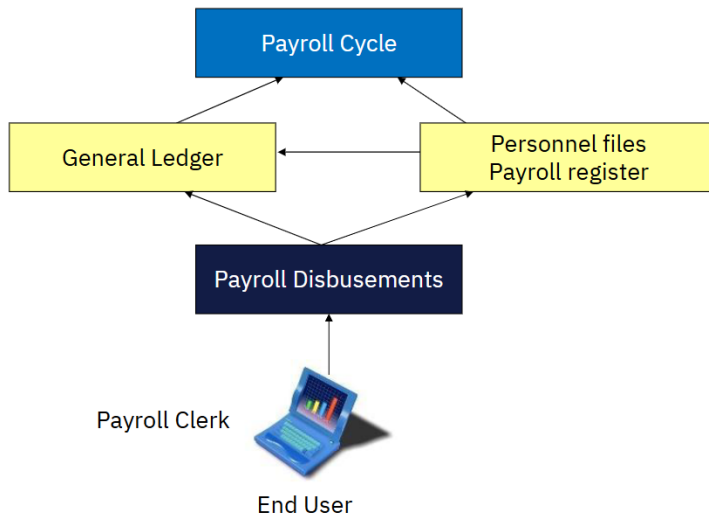
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Brainstorm – What Can Go Wrong?



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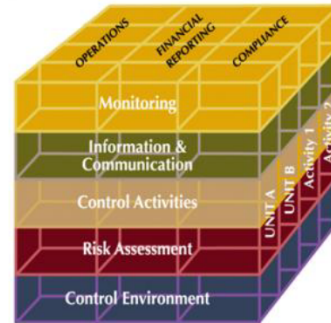
Documentation – Organized by COSO Principles

- **Control Environment**

- Commitment to integrity and ethical values
- TCWG exercise independent oversight of management
- Appropriate lines of authority and responsibility
- Commitment to competence
- Accountability

- **Risk assessment**

- Clarity of business objectives and related risks
- Analysis and management of business risks
- Consideration of the potential for fraud
- Risks of changes that affect internal controls



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Documentation – Organized by COSO Principles

- **Information and communication**

- Quality information used by internal controls
- Appropriate communication of information
- Appropriate communications with external parties

- **Monitoring**

- Ongoing evaluations of internal control systems
- Communication of internal control deficiencies to those responsible for corrective action

- **Control activities**

- Mitigate business risks
- General controls over IT
- Documented policies and procedures for significant financial statement accounts



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Understanding the Design and Implementation of Internal Control

COSO	Risk of Control Failure	Describe Controls	Change from PY	Nature of Change	Evaluation WP Ref	Design Gaps	Control Def	Compensating Controls	Adequately offset control deficiency	Risk of Material Misstatement	Tests of Controls	Overall Evaluation
Control Environ												
Risk Assess												
Information and communication												
Monitoring												
Control activities												

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Control Environment – Commitment to Competence

Risk of Failure

- Inaccuracies
- Failure to recognize need for special accounting or disclosure
- Inability to prepare financial statements

Design

- Inquiry of mgmt.
- Review of key positions
- Review of staffing needs

Implementation

- Inquires of employees
- Review personnel files
- Review IA reports
- Review of past AJEs and AU-C 265
- Review turnover and unfilled positions

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Control Environment – Organization Structure

Risk of Failure

- Not capture, record, or process key transactions
- Lack of resources resulting in lack of timely reports
- Lack of internal communication
- IA not perform adequately

Design

- Review org chart
- Inquiry key mgmt.
- Review of ownership of key data

Implementation

- Inquiry of mgmt.
- Inquiry of finance

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Understanding Activity-level Controls

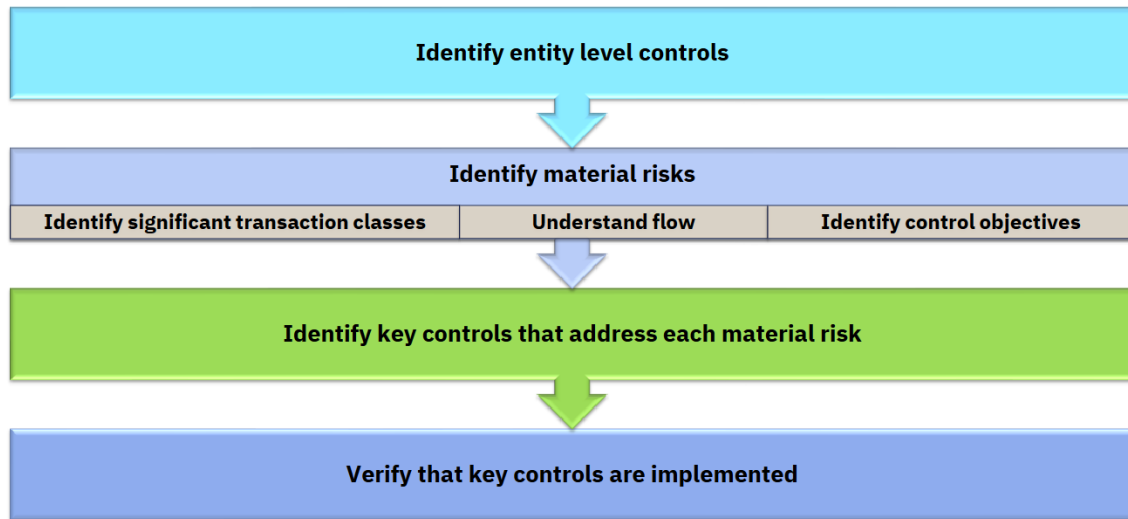
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Top-down, Risk-based Approach



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Understanding the Flow of Transactions

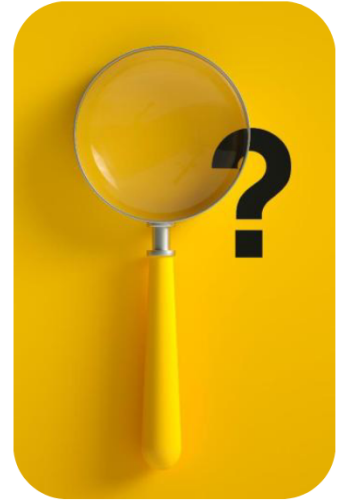
- Initiation, recording, processing and reporting
- Manual and electronic procedures
- Accounting records supporting the information
- Specific accounts involved
- How incorrect postings are resolved



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Identify How Material Misstatements Could Occur

- Control objectives
- What can go wrong?



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Example Control Objectives

- All recorded sales are valid
- All valid sales are recorded
- Sales are recorded in the appropriate period
- Sales are recorded in the appropriate account
- Sales are recorded at the correct amount



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Identifying Key Controls

Objectives	Control 1	Control 2	Control 3	Control 4	Control 5	Control 6
Recorded sales are valid	X			X		X
Valid sales are recorded		X			X	X
Recorded in proper period			X		X	
Recorded at proper amount					X	X
Recorded in proper account		X			X	

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Key Controls Often Consist of...

- **Activity-level Controls**
 - Authorization
 - Segregation of duties
 - Safeguarding of assets
 - Reconciliations
- **Entity-level Controls**
 - Management reviews
 - IT security



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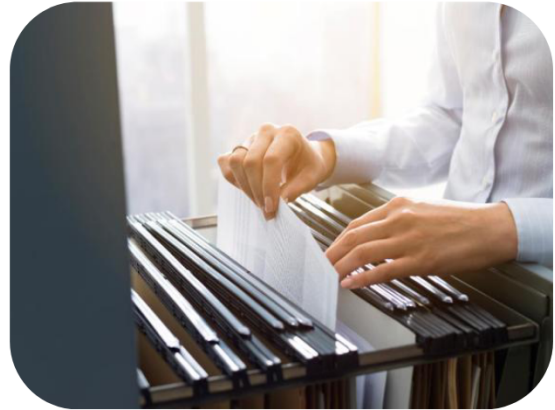


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Best Practices – Documentation

- Ensure evaluation links control objectives to controls
- Number controls in narrative
- Make controls client-specific



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Best Practices – Verify Implementation

- Focus on key controls ONLY!
- Ensure they include controls



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Process versus Control

- Selected employee #1234 and performed the following procedures, noting no exceptions:
 - Obtained the employee's 10/15/CY timecard, tied total hours per the card to 10/15/CY payroll register.
 - Obtained employee file and agreed rate/hour to the payroll register.
 - Recalculated the mathematical accuracy of total payroll for employee.
 - Footed payroll register and tied amount to the G/L account.
 - Footed G/L account and tied amount to F/S.

Where are the controls?

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Performing Walkthroughs

- Follow from initiation to recording
- Inquiry, observation and inspection
- Ask questions
- Differentiate between process and controls



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Walkthrough Documentation

Control and Relevant Assertion	Documents Examined	Walkthrough Procedures	Who Performs the Procedure	Exceptions	Corroborating Inquiries or Comments

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Best Practices – Evaluate Results

- Key controls designed effectively and implemented?
 - Consider testing key controls
- Design deficiencies and/or implementation deficiencies identified?
 - Document related identified risks for consideration on audit workprograms
 - List for assessment in accordance with AU-C 265
 - Control deficiency
 - Significant deficiency
 - Material weakness



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What if?

Control deficiency:

- Lack of segregation of duties in disbursements
- Owner review of bank statements is not consistent.

Risk of material misstatement identified:

- Accounting personnel can make fraudulent disbursements
- Existence – Expenses/Accounts Payable



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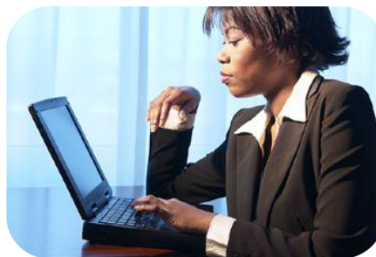


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Our Response

- Summarize disbursements by vendor. Review listing with owner for unknown or unexpected vendors.
- Run a test to determine whether any vendors have P.O. boxes or addresses that match addresses of the accounting personnel.
- Perform stronger, more precise analytics on expense accounts.



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Control Deficiencies = Risks

Control Objectives	Control 1	Control 2	Control 3	Control 4	Control 5	Control 6
Sales are valid	X			X		X
Valid sales are recorded		X			X	X
Recorded in proper period						
Recorded at proper amount					X	X
Recorded in proper account		X			X	

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Evaluating the Design and Implementation of the *Payroll Cycle*

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Cycle Controls

- Basic control policies and procedures
 - Time records
 - Paymaster records
 - Payroll register reconciliation
 - Employee verifications



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Benchmark Controls

- **Segregation:** Hiring, compensation, changes, terminations, payroll payments, payroll records
- **Authorizations:** Hires, compensation, classification, termination, disbursements
- **Reconciliations:** Master files, payroll register, bank statements, service organization
- **Competence of personnel**
- **Custody:** Check stock and signature stamps, wire transfer authority
- **Performance:** Budgets

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Compensation Rates and Payroll Deductions Authorized in Accordance w/Mgmt Criteria

Risk if Failure

- Unauthorized payments
- Violations of laws or regulations
- Diversion of cash

IC policies

- Statement of criteria
- Database mgmt.
- Document compensation adjustments
- Comparison of payments with authorization documents
- Trend analysis

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Sample Internal Control Evaluation–Revenue

	Assertions	Risk of Control Failure	Fraud or Significant Risk	Control Deficiencies	IT Dependent	Design Gaps	Test Controls?	Comments
Management review of budget to actual variances								
Accounting policies and procedures for treated of contract assets and liabilities								
Supporting analysis of deferred revenue								
Determination of all categories of revenue from contracts with customers								
Identification of distinct performance obligations								
Verify amounts of consideration expected to be received								

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Sample Internal Control Evaluation–Revenue

	Assertions	Risk of Control Failure	Fraud or Significant Risk	Control Deficiencies	IT Dependent	Design Gaps	Test Controls?	Comments
Proper allocation of transaction price to separate performance obligations								
Proper revenue recognition based upon transfer of control								
Reconcile changes in contract assets and contract liabilities								
Independent review of significant judgments and estimates performed at the end of every accounting period by knowledgeable personnel								
All write-offs and credit memos greater than specified amounts are approved								
Product margins by product line are reviewed								

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Instructor Contact Information

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- www.linkedin.com/in/ckmartin

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*Thank you
for joining us today.*

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GROUP STUDY MATERIALS

A. Discussion Questions

1. What factors should an engagement team consider when deciding whether to test controls?
2. How does successful control testing affect the design of substantive audit procedures?
3. What makes a substantive analytical procedure sufficiently persuasive?
4. How should an auditor address the portion of a population not selected through scope or judgmental testing?
5. How do attribute sampling and variable sampling differ?
6. Why is audit documentation especially important when professional judgment drives the audit response?

B. Suggested Answers to Discussion Questions

1. What factors should an engagement team consider when deciding whether to test controls?

The engagement team should begin with the inherent risk associated with the relevant assertion. If inherent risk is already low, reducing control risk may provide little benefit because the overall risk of material misstatement may already support limited substantive work. When inherent risk is moderate or high, the team should identify controls that are specifically designed to address that risk.

The next consideration is whether the controls have been properly designed and implemented. A control that does not address the relevant assertion or that has not actually been placed into operation is not a viable candidate for testing. The team must also determine whether persuasive evidence exists to show that the control operated throughout the period. A control may function in practice, but if the entity does not document its performance, the auditor may be unable to inspect sufficient evidence.

Cost-benefit considerations are also important. Testing controls should generally produce a meaningful reduction in substantive work. If testing the controls would take more time than performing substantive procedures, a substantive approach may be more efficient. Finally, the engagement team must be willing to rely on successful control-test results. Testing controls without modifying the nature, timing, or extent of substantive procedures creates work without a corresponding audit benefit.

2. How does successful control testing affect the design of substantive audit procedures?

Successful control testing can reduce the assessed control risk associated with a relevant assertion. Because inherent risk and control risk combine to form the risk of material misstatement, a lower control risk may reduce the amount of detection-risk work needed to bring overall audit risk to an acceptably low level.

The effect on substantive procedures may involve their nature, timing, or extent. For example, the auditor may use a smaller sample in a test of details, increase the dollar threshold used to select individually significant items, perform more work at an interim date, or rely more heavily on substantive analytical procedures. Strong controls may also permit the use of an analytical procedure with less precision or corroboration than would otherwise be necessary.

However, successful control testing does not eliminate all substantive procedures. Certain tests of details may be required by professional standards, and some substantive evidence remains necessary even in areas supported by effective controls. The appropriate reduction is a matter of professional judgment and should be directly linked to the assertion tested by the control.

The audit documentation should clearly show the relationship among the tested control, the achieved level of control risk, and the resulting modifications to substantive procedures. Without that linkage, a reviewer may be unable to understand how the control test contributed to the audit strategy.

3. What makes a substantive analytical procedure sufficiently persuasive?

A persuasive substantive analytical procedure begins with a predictable relationship and reliable underlying information. The auditor should be able to explain why the account or relationship is suitable for analytical testing. Comparisons may be based on prior periods, budgets, nonfinancial data, industry information, operating statistics, economic conditions, or relationships among financial statement accounts.

The procedure must also address the relevant assertion. An accounts receivable turnover calculation, for example, may provide meaningful evidence about the existence of receivables, but it may provide little evidence about valuation. The auditor should avoid treating a general fluctuation analysis as support for every assertion within the account.

Precision is another essential factor. Ratio, predictive, and regression analyses generally provide greater precision than a broad trend analysis. Disaggregating data by location, product line, customer, or salesperson may also reveal unusual results that would be hidden in aggregated information.

Before performing the procedure, the auditor should establish an expectation and define an acceptable difference. Significant differences must be investigated, and management's explanations should be corroborated with documentation or external evidence. Finally, the work should document the expectation, sources, reliability assessment, variance threshold, actual result, investigation, and conclusion so another experienced auditor could reperform the analysis.

4. How should an auditor address the portion of a population not selected through scope or judgmental testing?

Selecting individually significant or unusual items does not, by itself, provide evidence about the entire population. After testing scoped or judgmentally selected items, the auditor should quantify and evaluate the remaining untested portion. If that portion is material or carries more than a low risk of misstatement, additional audit work is necessary.

One option is to lower the scope threshold and test more individually significant items. Another is to apply audit sampling to the remaining population. Sampling is particularly appropriate when the remaining items are numerous and relatively homogeneous. The auditor may also use substantive analytical procedures when the remaining balance is predictable and reliable information is available to create a sufficiently precise expectation.

Reliance on tested controls may provide additional evidence about the untested portion. For example, if controls over transaction authorization and recording have been tested and found effective, the auditor may need less direct substantive testing than would otherwise be required. The auditor may also combine controls, analytics, and tests of details.

The key principle is that the auditor must obtain adequate coverage of the population rather than assume that large-dollar items represent all risks. Documentation should identify the tested and untested portions, compare the remaining balance with performance materiality, describe the procedures applied to it, and explain why the combined evidence is sufficient.

5. How do attribute sampling and variable sampling differ?

Attribute sampling is generally used in tests of controls and focuses on whether a particular control characteristic occurred. The result is ordinarily expressed as a deviation rate. For example, an auditor may inspect a sample of sales orders to determine whether each contains evidence of required approval. The dollar amount of the individual sales order is not necessarily relevant because the audit objective is to determine whether the control operated as designed.

Variable sampling is generally used in substantive tests of details and focuses on monetary amounts. Its purpose is to estimate or project the amount of misstatement within a population. The auditor may test a sample of accounts receivable balances, identify differences between recorded and audited amounts, and project those differences to the remaining population.

The factors affecting sample size also differ. Attribute sampling considers the control's frequency of operation, expected deviation rate, tolerable deviation rate, and desired level of control reliance. Variable sampling considers factors such as tolerable misstatement, expected misstatement, assessed risk, population value, and evidence obtained from other substantive procedures.

Both approaches require a properly defined population, representative item selection, evaluation of exceptions, and clear documentation. When a single procedure is designed as a dual-purpose test, the auditor should calculate both required sample sizes, use the larger sample, and separately evaluate control deviations and monetary misstatements.

6. Why is audit documentation especially important when professional judgment drives the audit response?

Professional judgment permits the auditor to tailor procedures to the entity rather than mechanically complete every step in a generic audit program. This flexibility improves efficiency, but it also creates a need for clear documentation. A reviewer must be able to understand not only what the auditor did, but why the auditor believed the procedures were appropriate.

For risk assessments, the file should explain why inherent and control risks were assessed at particular levels. For control testing, it should identify the control objective, relevant assertion, population, sample, procedures performed, deviations found, achieved reliance, and effect on substantive testing. For analytical procedures, it should describe the expectation, data sources, reliability, precision, acceptable variance, investigation, and conclusion.

Sampling documentation should define the population and sampling unit, explain the sample-size determination, identify the selection method, address replacements or untested items, and show how misstatements were projected and evaluated. Conclusions should be linked to the applicable account and assertion.

The standard of reperformance is a useful benchmark. An experienced auditor with no prior connection to the engagement should be able to understand the nature, timing, extent, and results of the work and, with client assistance, reperform it. Strong documentation makes the audit more defensible and helps supervisors, peer reviewers, regulators, and future engagement teams follow the audit story.

GLOSSARY

Analytical Procedure—An evaluation of financial information through plausible relationships among financial and nonfinancial data.

Attribute Sampling—A sampling method used primarily in tests of controls to evaluate whether a specified control characteristic occurred.

Cap-and-Trade Program—A market-based regulatory program in which a government sets an emissions cap and entities must hold permits or allowances for emissions, with the ability to buy or sell excess allowances.

Compliance Environmental Credit—An environmental credit that is probable of being used to settle an environmental credit obligation.

Control Risk—The risk that a material misstatement will not be prevented, or detected and corrected, by the entity's internal controls.

Detection Risk—The risk that audit procedures will fail to detect an existing material misstatement.

Dual-Purpose Test—A single audit procedure designed to serve both a test-of-controls objective and a substantive-testing objective.

Environmental Credit—An intangible, non-financial asset representing an enforceable right to prevent, control, reduce, or remove emissions or pollution, and that may be transferable or previously transferable.

Environmental Credit Obligation—An enforceable obligation arising from a regulatory compliance program that may be settled using environmental credits.

Inherent Risk—The susceptibility of an assertion to material misstatement before considering related internal controls.

Non-Compliance Environmental Credit—A recognized environmental credit that is not classified as a compliance environmental credit because it is not probable of being used to settle an environmental credit obligation.

Risk of Material Misstatement—The combined risk arising from inherent risk and control risk.

Stratification—The division of a population into groups with similar characteristics to reduce variability and improve sampling efficiency.

Tolerable Misstatement—The maximum monetary misstatement in a population that the auditor is willing to accept for a particular sampling procedure.

Variable Sampling—A substantive sampling method used to estimate the monetary amount of misstatement in a population.

Choose the best response and record your answer in the space provided on the answer sheet.

1. A compliance environmental credit is recognized as an asset when it is probable that the credit will be:
 - A. Used to settle an environmental credit obligation
 - B. Donated to charity for no environmental purpose
 - C. Used to settle income taxes
 - D. Written off immediately
2. Credits acquired solely to satisfy a voluntary net zero emissions initiative generally are:
 - A. Recognized as compliance environmental credit assets
 - B. Recorded as environmental credit obligations
 - C. Expensed as incurred, unless another qualifying use is probable
 - D. Always measured at fair value through earnings
3. Which statement correctly describes subsequent measurement of compliance environmental credits?
 - A. They are carried at cost as long as classification as compliance credits remains appropriate.
 - B. They are always impaired each reporting period.
 - C. They are always remeasured to fair value through other comprehensive income.
 - D. They are immediately derecognized after acquisition.
4. For an environmental credit obligation, the unfunded portion is generally measured based on:
 - A. The carrying amount of credits already held
 - B. The fair value of credits needed to settle the remaining obligation
 - C. The original cost of all credits ever purchased
 - D. Zero, because no credits have been acquired
5. Under the presentation guidance described in the transcript, compliance environmental credit assets and environmental credit obligations should be:
 - A. Presented net as a single balance
 - B. Excluded from the financial statements
 - C. Presented only in the statement of cash flows
 - D. Presented separately, because net presentation is not permitted

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6. Why might an auditor prefer a monthly management review control over a transaction-level control?
- A. Monthly controls never require documentation
 - B. Monthly controls always eliminate substantive testing
 - C. An infrequently operating control may require fewer items to test
 - D. Transaction-level controls are prohibited
7. An auditor planned to achieve low control risk but found more deviations than allowed for that level. What may the auditor do?
- A. Ignore the deviations if they appear unintentional
 - B. Automatically issue a modified opinion
 - C. Assess control risk at a higher level supported by the results
 - D. Reduce substantive testing anyway
8. Which analytical procedures are required under generally accepted auditing standards as described in the presentation?
- A. Only substantive analytical procedures
 - B. Preliminary and final analytical procedures
 - C. Only regression analyses
 - D. Substantive analytics for every significant account
9. Which analytical technique is generally more precise than a simple trend analysis?
- A. Ratio analysis
 - B. Uncorroborated inquiry
 - C. General discussion with management
 - D. Reading prior-year workpapers without comparison
10. Which action can strengthen a substantive analytical procedure?
- A. Increasing aggregation
 - B. Using information without evaluating its reliability
 - C. Disaggregating data by product, location, or salesperson
 - D. Avoiding investigation of unexpected differences

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11. An auditor expects accounts receivable of approximately \$100,000, but the recorded balance is \$300,000. What should the auditor do first?
- A. Conclude that fraud occurred
 - B. Accept management's verbal explanation without evidence
 - C. Investigate the difference and corroborate the explanation
 - D. Adjust the expected amount to equal the client's balance
12. What does "100% coverage" mean when an auditor uses a scope to test individually significant items?
- A. Every transaction must be inspected
 - B. The auditor must address both the tested and untested portions of the population
 - C. Sampling is prohibited
 - D. The scope threshold must equal zero
13. In substantive audit sampling, "tolerable misstatement" is most closely related to:
- A. Performance materiality
 - B. Expected control deviation rate
 - C. The number of control occurrences
 - D. Engagement staffing levels
14. What is the principal benefit of stratifying a population before substantive sampling?
- A. It eliminates the need to project misstatements
 - B. It reduces variability within groups and may lower sampling risk
 - C. It guarantees that no misstatement exists
 - D. It permits the auditor to omit individually significant items
15. When performing a dual-purpose test, which sample size should ordinarily be used?
- A. The smaller of the control and substantive sample sizes
 - B. The average of the two sample sizes
 - C. A sample of one item from each population
 - D. The larger of the control and substantive sample sizes

Subscriber Survey

Evaluation Form

Please take a few minutes to complete this survey related to **CeriFi CPE Network A&A Report** and return with your quizzer or group attendance sheet to CeriFi, LLC. All responses will be kept confidential. Comments in addition to the answers to these questions are also welcome. Please send comments to grading-cpedge@cerifi.com.

How would you rate the topics covered in this issue of **CeriFi CPE Network A&A Report**? Rate each topic on a scale of 1–5 (5=highest):

	Topic Relevance	Topic Content/ Coverage	Topic Timeliness	Video Quality	Audio Quality	Written Material
Audit & Accounting Part 1						
Audit & Accounting Part 2						

Which segments of this issue of **CeriFi CPE Network A&A Report** did you like the most, and why?

Which segments of this issue of **CeriFi CPE Network A&A Report** did you like the least, and why?

What would you like to see included or changed in future issues of **CeriFi CPE Network A&A Report**?

How would you rate the effectiveness of the speakers in this issue of **CeriFi CPE Network A&A Report**? Rate each speaker on a scale of 1–5 (5 highest):

	Overall	Knowledge of Topic	Presentation Skills
Ms. Jennifer Louis	_____	_____	_____
Mr. Christopher K. Martin	_____	_____	_____

Are you using **CeriFi CPE Network A&A Report** for: CPE Credit ☐ Information ☐ Both ☐

Were the stated learning objectives met? Yes ☐ No ☐ _____

If applicable, were prerequisite requirements appropriate? Yes ☐ No ☐ _____

Were program materials accurate? Yes ☐ No ☐ _____

Were program materials relevant and contribute to the achievement of the learning objectives? Yes ☐ No ☐ _____

Were the time allocations for the program appropriate? Yes ☐ No ☐ _____

Were the supplemental reading materials satisfactory? Yes ☐ No ☐ _____

Were the discussion questions and answers satisfactory? Yes ☐ No ☐ _____

Specific Comments:

Name/Company _____

Address _____

City/State/Zip _____

Email _____

Once Again, Thank You...

Your Input Can Have a Direct Influence on Future Issues!

CPE Group Attendance Sheet

Firm/Company Name: _____

Account #: _____

Location: _____

Program Title: CeriFi CPE Network Accounting & Auditing Report, August 2026 Date: _____

<u>Name</u>	<u>Email</u>	<u>Total Hrs</u>	<u>IRS PTIN ID (if applicable Tax only)</u>	<u>Sign In</u>	<u>Sign Out</u>
_____	_____	_____	_____	_____	_____
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I certify that the above individuals viewed and were participants in the group discussion with this issue/segment of the CeriFi CPE Network newsletter, and earned the number of hours shown.

Instructor Name: _____ Date: _____

E-mail address: _____

License State and Number: _____

CPE Session Requirements

- Must be 3 CPE credits (min. 2.5 hours); see User Guide.
- Record actual time attended if participant arrives late or leaves early.

Within 30 days, submit all of the following to grading-cpedge@cerifi.com

- Advertising/Promotional Page
- CPE Group Attendance Sheet
- Subscriber Survey Evaluation Form

Course Title	
Course Date:	
Start Time:	
End Time:	
Moderator Name, Credentials, and Signature Attestation of Attendance:	
Delivery Method:	Group Internet Based
Total CPE Credit:	3.0
Instructions:	During the webinar, the moderator must verify student presence a minimum of <u>3 times per CPE hour</u> . This is achieved via polling questions. Sponsors must have a report which documents the responses from each student. The timing of the polling questions should be random and not made known to students prior to delivery of the course. Record the polling question responses below. Refer to the CeriFi CPE Network User Guide for more instructions. Partial credit will not be issued for students who do not respond to at least 3 polling questions per CPE hour.
Brief Description of Method of Polling	Example: Zoom: During this webinar, moderator asked students to raise their hands 3 times per CPE hour. The instructor then noted the hands that were raised in the columns below.

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CERIFI CPE NETWORK USER GUIDE

REVISED August 2025

Welcome to CeriFi CPE Network!

CeriFi CPE Network programs enable you to deliver training programs to those in your firm in a manageable way. You can choose how you want to deliver the training in a way that suits your firm's needs: in the classroom, virtual, or self-study. You must review and understand the requirements of each of these delivery methods before conducting your training to ensure you meet (and document) all the requirements.

This User Guide has the following sections:

- **“Group Live” Format:** The instructor and all the participants are gathered into a common area, such as a conference room or training room at a location of your choice.
- **“Group Internet Based” Format:** Deliver your training over the internet via Zoom, Teams, Webex, or other application that allows the instructor to present materials that all the participants can view at the same time.
- **“Self-Study” Format:** Each participant can take the self-study version of the CeriFi CPE Network program on their own computers at a time and place of their convenience. No instructor is required for self-study.
- **What Does It Mean to Be a CPE Sponsor?:** Should you decide to vary from any of the requirements in the 3 methods noted above (for example, provide less than 3 full CPE credits, alter subject areas, offer hybrid or variations to the methods described above), CeriFi CPE Network will not be the sponsor and will not issue certificates. In this scenario, your firm will become the sponsor and must issue its own certificates of completion. This section outlines the sponsor's responsibilities that you must adhere to if you choose not to follow the requirements for the delivery methods.
- **Getting Help:** Refer to this section to get your questions answered.

IMPORTANT: This User Guide outlines in detail what is required for the formats above. Additionally, because you will be delivering the training within your firm, you should review the Sponsor Responsibilities section as well. To get certificates of completion for your participants following your training, you must submit all the required documentation. (This is noted at the end of each section.) CeriFi CPE Network will review your training documentation for completeness and adherence to all requirements. If all your materials are received and complete, certificates of completion will be issued for the participants attending your training. Failure to submit the required completed documentation will result in delays and/or denial of certificates.

IMPORTANT: If you vary from the instructions noted above, your firm will become the sponsor of the training event and you will have to create your own certificates of completions for your participants. In this case, you do not need to submit any documentation back to CeriFi, LLC.

If you have any questions on this documentation or requirements, refer to the “Getting Help” section at the end of this User Guide **BEFORE** you conduct your training.

We are happy that you chose CeriFi CPE Network for your training solutions.

Thank you for your business and HAPPY LEARNING!

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“Group Live” Format

CPE Credit

All CeriFi CPE Network products are developed and intended to be delivered as 3 CPE credits. You should allocate sufficient time in your delivery so that there is no less than 2.5 clock hours:

50 minutes per CPE credit TIMES 3 credits = 150 minutes = 2.5 clock hours

If you wish to have a break during your training session, you should increase the length of the training beyond 2.5 hours as necessary. For example, you may wish to schedule your training from 9 AM to 12 PM and provide a ½ hour break from 10:15 to 10:45.

***Effective November 1, 2018:** CeriFi CPE Network products ‘group live’ sessions must be delivered as 3 CPE credits and accredited to the field(s) of study as designated by CeriFi CPE Network. CeriFi CPE Network will not issue certificates for “group live” deliveries of less than 3 CPE credits (unless the course was delivered as 3 credits and there are partial credit exceptions (such as late arrivals and early departures). Therefore, if you decide to deliver the “group live” session with less than 3 CPE credits, your firm will be the sponsor as CeriFi CPE Network will not issue certificates to your participants.

Advertising / Promotional Page

Create a promotion page (use the template after the executive summary of the transcript). You should circulate (e.g., email) to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

Monitoring Attendance

You must monitor individual participant attendance at “group live” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **attendance sheet**. This lists the instructor(s) name and credentials, as well as the first and last name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant arrives late, leaves early, or is a “no show,” the actual hours they attended should be documented on the sign-in sheet and will be reflected on the participant’s CPE certificate.

Real Time Instructor During Program Presentation

“Group live” programs must have a **qualified, real time instructor while the program is being presented**. Program participants must be able to interact with the instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

Elements of Engagement

A “group live” program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

Make-Up Sessions

Individuals who are unable to attend the group study session may use the program materials for self-study online.

- If the emailed materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Answer Sheet. Send the answer sheet and course evaluation to the email address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual CeriFi account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his/their CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

Awarding CPE Certificates

The CPE certificate is the participant’s record of attendance and is awarded by CeriFi CPE Network after the “group live” documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early.

Subscriber Survey Evaluation Forms

Use the evaluation form. You must include a means for evaluating quality. At the conclusion of the “group live” session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to CeriFi CPE Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

Retention of Records

Regardless of whether CeriFi CPE Network is the sponsor for the “group live” session, it is required that the firm hosting the “group live” session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Group Study Attendance sheets; indicating any late arrivals and/or early departures)
- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations.

Finding the Transcript

The entire transcript is available as a pdf via the link in the email sent to administrators.

Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your “group live” session should be sent to CeriFi CPE Network by the following means:

Email: grading-cpedge@cerifi.com

When sending your package to CeriFi, you must include ALL of the following items:

Form Name	Included?	Notes
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Attendance Sheet		Use this form to track attendance during your training session.
Subscriber Survey Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to CeriFi any evaluations that were completed. You do not have to return an evaluation for every participant.

Incomplete submissions will be returned to you.

“Group Internet Based” Format

CPE Credit

All CeriFi CPE Network products are developed and intended to be delivered as 3 CPE credits. You should allocate sufficient time in your delivery so that there is no less than 2.5 clock hours:

50 minutes per CPE credit TIMES 3 credits = 150 minutes = 2.5 clock hours

If you wish to have a break during your training session, you should increase the length of the training beyond 2.5 hours as necessary. For example, you may wish to schedule your training from 9 AM to 12 PM and provide a ½ hour break from 10:15 to 10:45.

***Effective November 1, 2018:** CeriFi CPE Network products ‘group live’ sessions must be delivered as 3 CPE credits and accredited to the field(s) of study as designated by CeriFi CPE Network. CeriFi CPE Network will not issue certificates for “group live” deliveries of less than 3 CPE credits (unless the course was delivered as 3 credits and there are partial credit exceptions (such as late arrivals and early departures. Therefore, if you decide to deliver the “group live” session with less than 3 CPE credits, your firm will be the sponsor as CeriFi CPE Network will not issue certificates to your participants.

Advertising / Promotional Page

Create a promotion page (use the template following the executive summary in the transcript. You should circulate (e.g., email to potential participants prior to training day. You will need to submit a copy of this page when you request certificates.

Monitoring Attendance in a Webinar

You must monitor individual participant attendance at “group internet based” programs to assign the correct number of CPE credits. A participant’s self-certification of attendance alone is not sufficient.

Use the **Webinar Delivery Tracking Report**. This form lists the moderator(s) name and credentials, as well as the first and last name of each participant attending the seminar. During a webinar you must set up a monitoring mechanism (or polling mechanism to periodically check the participants’ engagement throughout the delivery of the program. Participants’ two-way video should remain on during the entire presentation.

In order for CPE credit to be granted, you must confirm the presence of each participant **3 times per CPE hour and the participant must reply to the polling question**. Participants that respond to less than 3 polling questions in a CPE hour will not be granted CPE credit. For example, if a participant only replies to 2 of the 3 polling questions in the first CPE hour, credit for the first CPE hour will not be granted. (Refer to the Webinar Delivery Tracking Report for examples.)

Examples of polling questions:

1. You are using **Zoom** for your webinar. The moderator pauses approximately every 15 minutes and asks that participants confirm their attendance by using the “raise hands” feature. Once the participants raise their hands, the moderator records the participants who have their hands up in the **webinar delivery tracking report** by putting a YES in the webinar delivery tracking report. After documenting in the spreadsheet, the instructor (or moderator) drops everyone’s hands and continues the training.
2. You are using **Teams** for your webinar. The moderator will pause approximately every 15 minutes and ask that participants confirm their attendance by typing “Present” into the Teams chat box. The moderator records the participants who have entered “Present” into the chat box into the **webinar delivery tracking report**. After documenting in the spreadsheet, the instructor (or moderator) continues the training.
3. If you are using an application that has a way to automatically send out polling questions to the participants, you can use that application/mechanism. However, following the event, you should create a **webinar delivery tracking report** from your app’s report.

Additional Notes on Monitoring Mechanisms:

1. The monitoring mechanism does not have to be “content specific.” Rather, the intention is to ensure that the remote participants are present and paying attention to the training.
2. You should only give a minute or so for each participant to reply to the prompt. If, after a minute, a participant does not reply to the prompt, you should put a NO in the webinar delivery tracking report.
3. While this process may seem unwieldy at first, it is a required element that sponsors must adhere to. And after some practice, it should not cause any significant disruption to the training session.
4. **You must include the Webinar Delivery Tracking report with your course submission if you are requesting certificates of completion for a “group internet based” delivery format.**

Real Time Moderator During Program Presentation

“Group internet based” programs must have a **qualified, real time moderator while the program is being presented**. Program participants must be able to interact with the moderator while the course is in progress (including the opportunity to ask questions and receive answers during the presentation). This can be achieved via the webinar chat box, and/or by unmuting participants and allowing them to speak directly to the moderator.

Where individual participants log into a group live program they are required to enable two-way video to participate in a virtual face-to-face setting (with cameras on), elements of engagement are required (such as group discussion, polling questions, instructor posed questions with time for reflection, or a case study with engagement throughout the presentation) in order to award CPE credits to the participants. Participation in the two-way video conference must be monitored and documented by the instructor or attendance monitor in order to authenticate attendance for program duration. The participant-to-attendance monitor ratio must not exceed 25:1, unless there is a dedicated attendance monitor in which case the participant-to-attendance monitor ratio must not exceed 100:1.

Make-Up Sessions

Individuals who are unable to attend the “group internet based” session may use the program materials for self-study either in print or online.

- If emailed materials are used, the user should read the materials, watch the video, and answer the quizzer questions on the CPE Answer Sheet. Send the answer sheet and course evaluation to the email address listed on the answer sheet and the CPE certificate will be mailed or emailed to the user. Detailed instructions are provided on Network Program Self-Study Options.
- If the online materials are used, the user should log on to her/his individual CeriFi CPE account to read the materials, watch the interviews, and answer the quizzer questions. The user will be able to print her/his CPE certificate upon completion of the quizzer. (If you need help setting up individual user accounts, please contact your firm administrator or customer service.)

Awarding CPE Certificates

The CPE certificate is the participant’s record of attendance and is awarded by CeriFi CPE Network after the “group internet based” documentation is received (and providing the course is delivered as 3 CPE credits). The certificate of completion will reflect the credit hours earned by the individual, with special calculation of credits for those who may not have answered the required amount of polling questions.

Subscriber Survey Evaluation Forms

Use the evaluation form. You must include a means for evaluating quality. At the conclusion of the “group live” session, evaluations should be distributed and any that are completed are collected from participants. Those evaluations that are completed by participants should be returned to CeriFi CPE Network along with the other course materials. While it is required that you circulate the evaluation form to all participants, it is NOT required that the participants fill it out. A preprinted evaluation form is included in the transcript each month for your convenience.

Retention of Records

Regardless of whether CeriFi CPE Network is the sponsor for the “group internet based” session, it is required that the firm hosting the session retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (Webinar Delivery Tracking Report)
- Copy of the program materials
- Timed agenda with topics covered
- Date and location (which would be “virtual”) of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name and credentials
- Results of program evaluations

Finding the Transcript

The email sent to administrators each month has a link to the pdf for the newsletter. The email may be forwarded to participants who may download the materials or print them as needed.

Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your “group internet based” session should be sent to CeriFi CPE Network by the following means:

Email: grading-cpedge@cerifi.com

When sending your package to CeriFi, you must include ALL the following items:

Advertising /		Complete this form and circulate to your audience
Webinar Delivery		Use this form to track the attendance (i.e., polling
Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to CeriFi any evaluations that were completed. You do not have to

Incomplete submissions will be returned to you.

“Self-Study” Format

If you are unable to attend the live group study session, we offer two options for you to complete your Network Report program.

Self-Study—Email

Follow these simple steps to use the printed transcript and video:

- Watch the video.
- Review the supplemental materials.
- Read the discussion problems and the suggested answers.
- Complete the quizzer by filling out the bubble sheet enclosed with the transcript package.
- Complete the survey. We welcome your feedback and suggestions for topics of interest to you.
- E-mail your completed quizzer and survey to:

grading-cpedge@cerifi.com

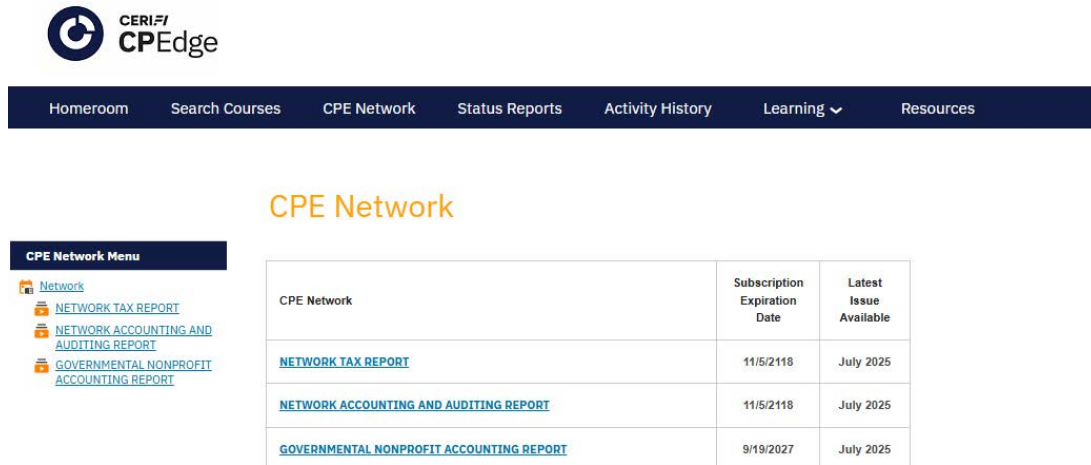
Self-Study—Online

Follow these simple steps to use the online program:

- Go to <https://cerificpedge.com/>.
- Log in using your username and password assigned by your firm’s administrator in the upper right-hand margin (“Login or Register”).

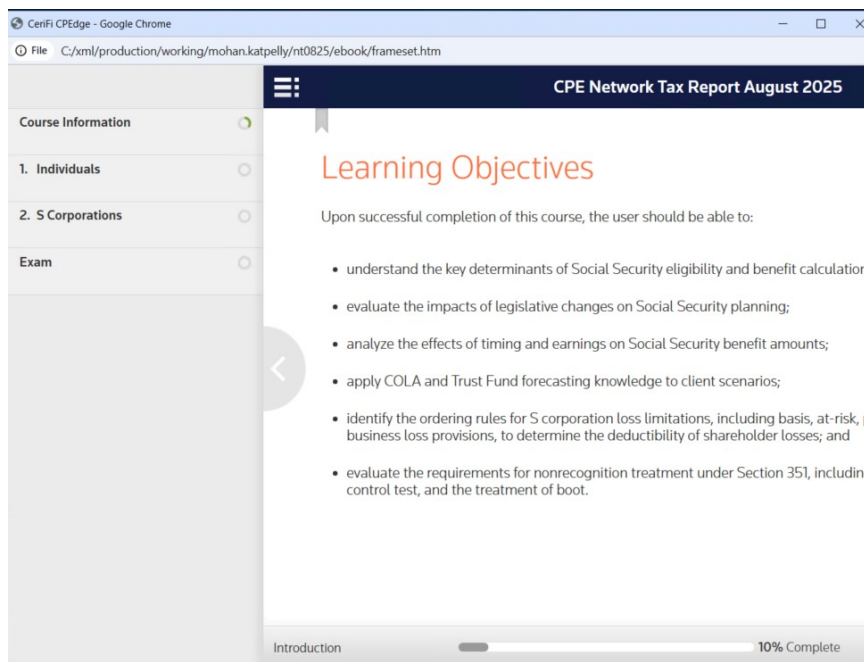
The screenshot shows the CeriFi CPEdge website. At the top, there is a navigation bar with the text "CHECKPOINT LEARNING IS NOW" and the CeriFi CPEdge logo. To the right of the logo are links for "Contact Us", a shopping cart icon, and a "Login" button. Below the navigation bar is a search bar with the placeholder text "Search courses". A blue banner below the search bar reads "Checkpoint Learning is now CeriFi CPEdge!". The main content area features the heading "CeriFi CPEdge CPE for CPAs" and a subheading "The highest quality continuing professional education for CPAs and EAs looking to grow their knowledge in tax, accounting, finance, and more." Below this, there are three columns of content: "Achieve your goals, your way." with links to "Stay up to date", "Grow your expertise", "Learn the way you like", and "Upskill your organization"; "Formats for every learning style and schedule." with links to "Live events" (Webinars and Virtual Conferences, Seminars, Conferences) and "On-demand courses" (Self Study and Online Grading, Nano Courses, Video Learning, On-Demand Webinars). A woman wearing glasses and a headset is visible on the right side of the page.

- In the **CeriFi CPE Network** tab, select the desired Network Report and then the appropriate edition.



CPE Network	Subscription Expiration Date	Latest Issue Available
NETWORK TAX REPORT	11/5/2118	July 2025
NETWORK ACCOUNTING AND AUDITING REPORT	11/5/2118	July 2025
GOVERNMENTAL NONPROFIT ACCOUNTING REPORT	9/19/2027	July 2025

The Chapter Menu is in the gray bar at the left of your screen:



CPE Network Tax Report August 2025

Learning Objectives

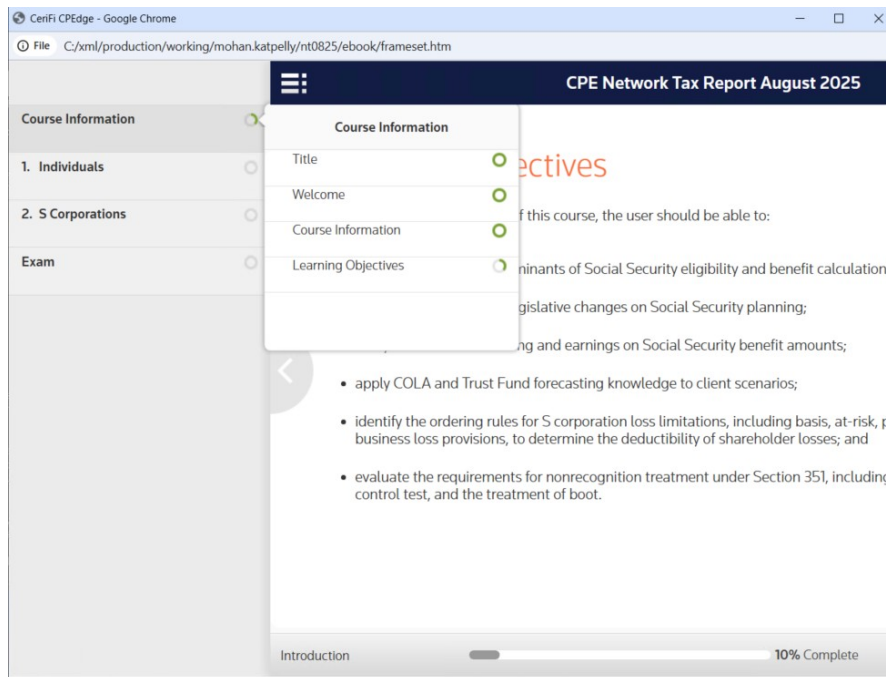
Upon successful completion of this course, the user should be able to:

- understand the key determinants of Social Security eligibility and benefit calculation;
- evaluate the impacts of legislative changes on Social Security planning;
- analyze the effects of timing and earnings on Social Security benefit amounts;
- apply COLA and Trust Fund forecasting knowledge to client scenarios;
- identify the ordering rules for S corporation loss limitations, including basis, at-risk, pe business loss provisions, to determine the deductibility of shareholder losses; and
- evaluate the requirements for nonrecognition treatment under Section 351, including control test, and the treatment of boot.

Introduction 10% Complete

Click down to access the dropdown menu and move between the program Chapters.

- **Course Information** is the course Overview, including information about the authors and the program learning objectives



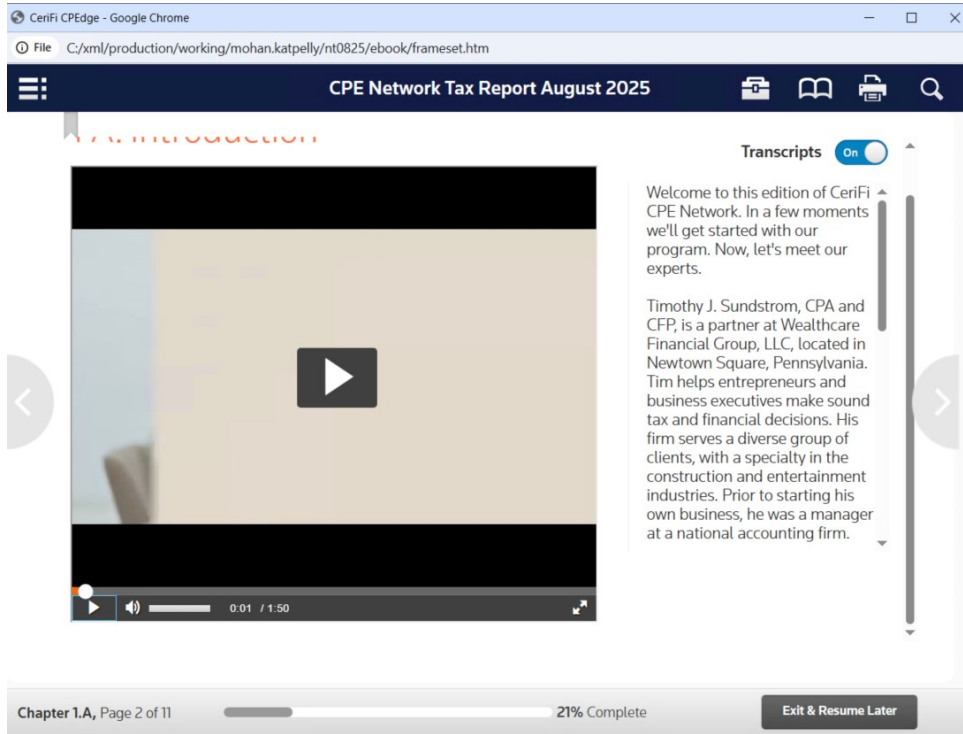
- **Each Chapter is self-contained.** Each chapter contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental materials, and then the self-study questions. This streamlined approach allows administrators and users to more easily access the related materials.



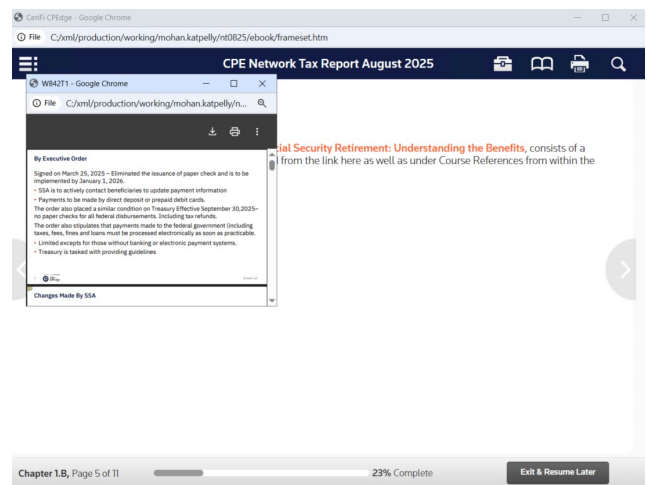
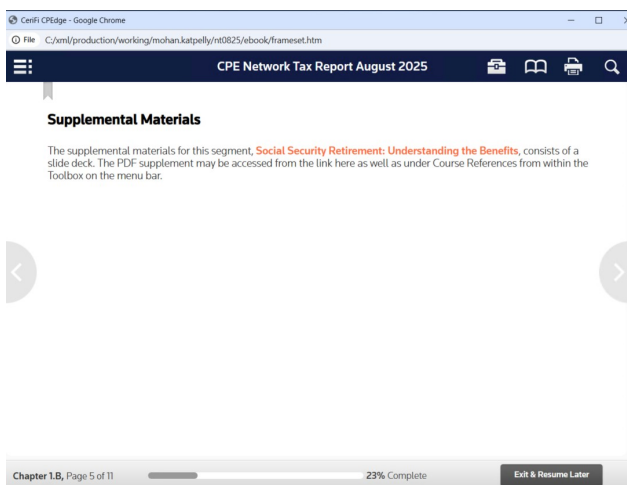
Video segments may be downloaded from the player by clicking on the download button. *Tip: you may need to scroll down to see the download button.*

Transcripts for the interview segments can be viewed at the right side of the screen via a toggle button at the top labeled **Transcripts**

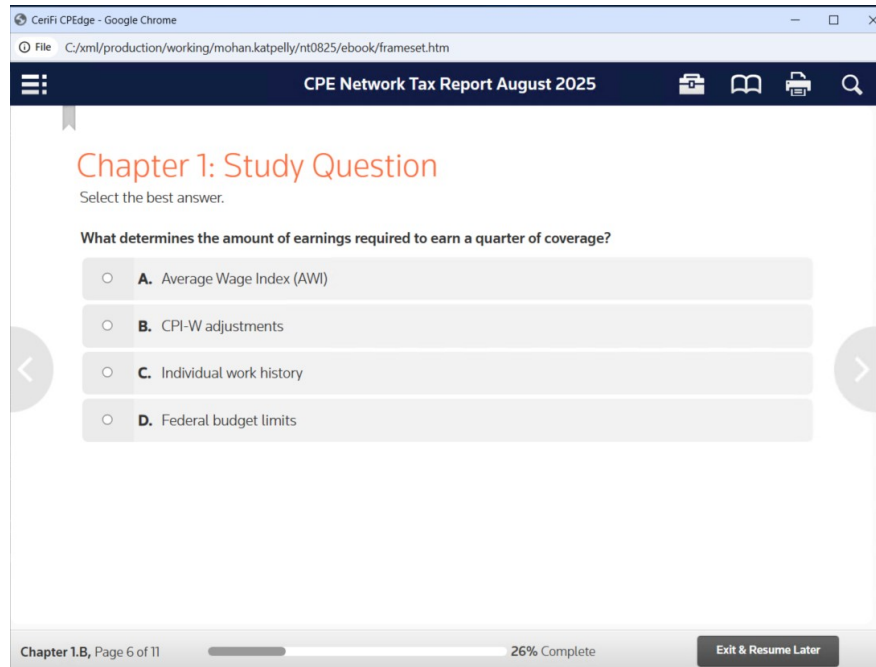
Click the arrow at the bottom of the video to play it, or click the arrow to the right side of the screen to advance to the supplemental material.



The supplemental materials are available via the toolbox and the link will pop up the pdf version in a separate window.

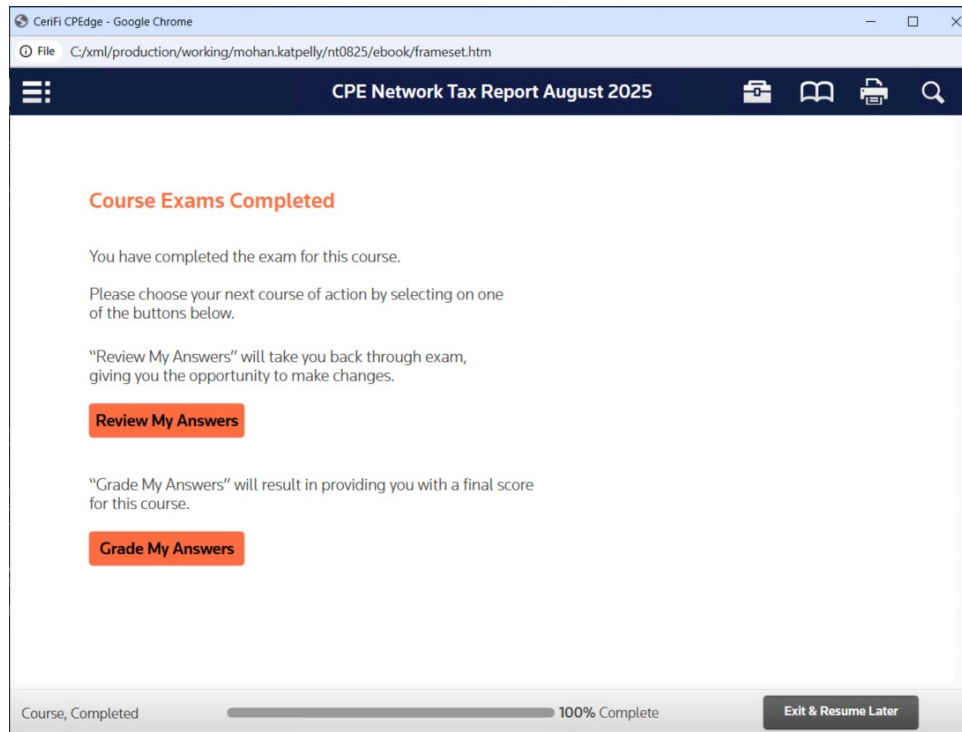


Continuing to click the arrow to the right side of the screen will bring the user to the self-study questions related to the segment.



The **Exam** is accessed by clicking the last gray bar on the menu at the left of the screen or clicking through to it. Click the orange button to begin.

When you have completed the quizzer, click the button labeled **Grade or the Review button**.



- Click the button labeled **Certificate** to print your CPE certificate.
- The quizzer grade is displayed and you may view the graded answers by clicking the button labeled **view graded answer**.

Additional Features Search

CeriFi CPE offers powerful search options. Click the **magnifying glass** at the upper right of the screen to begin your search. Enter your choice in the **Search For:** box.

Search Results are displayed with the number of hits.

Print

To display the print menu, click the printer icon in the upper bar of your screen. You can print the entire course, the transcript, the glossary, all resources, or selected portions of the course. Click your choice and click the orange **Print**.

What Does It Mean to Be a CPE Sponsor?

If your organization chooses to vary from the instructions outlined in this User Guide, your firm will become the CPE Sponsor for this monthly series. The sponsor rules and requirements noted below are only highlights and reflect those of NASBA, the national body that sets guidance for development, presentation, and documentation for CPE programs. **For any specific questions about state sponsor requirements, please contact your state board. They are the final authority regarding CPE Sponsor requirements.** Generally, the following responsibilities are required of the sponsor:

- Arrange for a location for the presentation
- Advertise the course to your anticipated participants and disclose significant features of the program in advance
- Set the start time
- Establish participant sign-in procedures
- Coordinate audio-visual requirements with the facilitator
- Arrange appropriate breaks
- Have a real-time instructor during program presentation
- Ensure that the instructor delivers and documents elements of engagement
- Monitor participant attendance (make notations of late arrivals, early departures, and “no shows”)
- Solicit course evaluations from participants
- Award CPE credit and issue certificates of completion
- Retain records for five years

The following information includes instructions and generic forms to assist you in fulfilling your responsibilities as program sponsor.

CPE Sponsor Requirements

Determining CPE Credit Increments

Sponsored seminars are measured by program length, with one 50-minute period equal to one CPE credit. One-half CPE credit increments (equal to 25 minutes) are permitted after the first credit has been earned. Sponsors must monitor the program length and the participants' attendance in order to award the appropriate number of CPE credits.

Program Presentation

CPE program sponsors must provide descriptive materials that enable CPAs to assess the appropriateness of learning activities. CPE program sponsors must make the following information available in advance:

- Learning objectives.
- Instructional delivery methods.
- Recommended CPE credit and recommended field of study.
- Prerequisites.
- Program level.
- Advance preparation.
- Program description.
- Course registration and, where applicable, attendance requirements.
- Refund policy for courses sold for a fee/cancellation policy.
- Complaint resolution policy.
- Official NASBA sponsor statement, if an approved NASBA sponsor (explaining final authority of acceptance of CPE credits).

Disclose Significant Features of Program in Advance

For potential participants to effectively plan their CPE, the program sponsor must disclose the significant features of the program in advance (e.g., through the use of brochures, website, electronic notices, invitations, direct mail, or other announcements). When CPE programs are offered in conjunction with non-educational activities, or when several CPE programs are offered concurrently, participants must receive an appropriate schedule of events indicating those components that are recommended for CPE credit. The CPE program sponsor's registration and attendance policies and procedures must be formalized, published, and made available to participants and include refund/cancellation policies as well as complaint resolution policies.

Monitor Attendance

While it is the participant's responsibility to report the appropriate number of credits earned, CPE program sponsors must maintain a process to monitor individual attendance at group programs to assign the correct number of CPE credits. A participant's self-certification of attendance alone is not sufficient. The sign-in sheet should list the names of each instructor and her/his credentials, as well as the name of each participant attending the seminar. The participant is expected to initial the sheet for their morning attendance and provide their signature for their afternoon attendance. If a participant leaves early, the hours they attended should be documented on the sign-in sheet and on the participant's CPE certificate.

Real Time Instructor During Program Presentation

“Group live” programs must have a qualified, real-time instructor while the program is being presented. Program participants must be able to interact with the real time instructor while the course is in progress (including the opportunity to ask questions and receive answers during the presentation).

Elements of Engagement

A “group live” program must include at least one element of engagement related to course content during each credit of CPE (for example, group discussion, polling questions, instructor-posed question with time for participant reflection, or use of a case study with different engagement elements throughout the program).

Awarding CPE Certificates

The CPE certificate is the participant’s record of attendance and is awarded at the conclusion of the seminar. It should reflect the credit hours earned by the individual, with special calculation of credits for those who arrived late or left early.

CFP credit is available if the firm registers with the CFP board as a sponsor and meets the CFP board requirements. IRS credit is available only if the firm registers with the IRS as a sponsor and satisfies their requirements.

Seminar Quality Evaluations for Firm Sponsor

NASBA requires the seminar to include a means for evaluating quality. At the seminar conclusion, evaluations should be solicited from participants and retained by the sponsor for five years. The following statements are required on the evaluation and are used to determine whether:

1. Stated learning objectives were met.
2. Prerequisite requirements were appropriate (if any).
3. Program materials were accurate.
4. Program materials were relevant and contributed to the achievement of the learning objectives.
5. Time allotted to the learning activity was appropriate.
6. Individual instructors were effective.
7. Facilities and/or technological equipment were appropriate.
8. Handout or advance preparation materials were satisfactory.
9. Audio and video materials were effective.

You may use the enclosed preprinted evaluation forms for your convenience.

Retention of Records

The seminar sponsor is required to retain the following information for a period of five years from the date the program is completed unless state law dictates otherwise:

- Record of participation (the original sign-in sheets, now in an editable, electronic signable format)
- Copy of the program materials
- Timed agenda with topics covered and elements of engagement used
- Date and location of course presentation
- Number of CPE credits and field of study breakdown earned by participants
- Instructor name(s) and credentials
- Results of program evaluations

Appendix: Forms

Here are the forms noted above and how to get access to them.

Delivery Method	Form Name	Location	Notes
"Group Live" / "Group Internet Based"	Advertising / Promotional Page	Transcript	Complete this form and circulate to your audience before the training event.
"Group Live"	Attendance Sheet	Transcript	Use this form to track attendance during your training session.
"Group Internet Based"	Webinar Delivery Tracking Report	Transcript	Use this form to track the 'polling questions' which are required to monitor attendance during your webinar.
"Group Live" / "Group Internet Based"	Evaluation Form	Transcript	Circulate the evaluation form at the end of your training session so that participants can review and comment on the training.
Self Study	CPE Answer Sheet	Transcript	Use this form to record your answers to the quizzer.

Getting Help

Should you need support or assistance with your account, please see below:

Support Group	Phone Number	Email Address	Typical Issues/Questions
Technical Support	844.245.5970	cpedgesupport@cerifi.com	• Browser-based • Certificate discrepancies • Accessing courses • Migration questions • Feed issues
Product Support	844.245.5970	cpedgesupport@cerifi.com	• Functionality (how to use, where to find) • Content questions • Login Assistance
Customer Support	844.245.5970	cpedgesupport@cerifi.com	• Billing • Existing orders • Cancellations • Webinars • Certificates