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CPE NETWORK

ACCOUNTING & AUDITING REPORT

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EXECUTIVE SUMMARY

PART 1. ACCOUNTING

Susan Longo, CPA, examines critical aspects of fraud detection and regulatory compliance within SSARS 25, focusing on identifying and addressing potential fraud schemes and scams that accountants must recognize in their practice. This session guides you through effective fraud interview techniques and the strategic use of analytical procedures to assess risk, while providing practical approaches for meeting SSARS requirements regarding fraud and noncompliance with laws and regulations. The discussion explores how senior accounting professionals can enhance their fraud detection capabilities, implement proper documentation procedures, and maintain professional skepticism throughout their engagements. By the end, participants will be equipped to identify requirements within recent authoritative standards and effectively address frequently asked questions related to these evolving standards, ultimately strengthening their ability to detect and respond to potential fraud risks in their practice.

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

- Identify specific requirements within recent authoritative standards.
- Develop ability to pose and answer frequently asked questions related to recent standards.
- Explain recent changes in accounting rules to staff professionals and client personnel

PART 2. AUDITING

Christopher Martin, CPA, explores the essential components and strategic considerations of initial audit engagements, examining how practitioners should approach client acceptance, risk assessment, and procedure selection when taking on new audit clients. This session guides you through the specific requirements and best practices unique to initial audits, exploring how to effectively evaluate client-specific risks, design appropriate initial audit procedures, and establish a strong foundation for ongoing audit relationships. The discussion addresses critical decision points in the client acceptance process, risk assessment considerations unique to first-year engagements, and practical approaches for developing effective initial audit strategies across common audit areas. By the end, participants will be equipped to execute comprehensive initial audit procedures, evaluate key acceptance criteria and risk factors, and implement appropriate audit approaches tailored to new client engagements.

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

- List required and common audit procedures in an initial audit engagement.
- Evaluate key risk assessment and client acceptance issues.
- Determine the initial audit approach for common audit areas

ABOUT THE SPEAKERS

Susan C. Longo, CPA, MBA, Susan C. Longo, CPA, provides financial reporting services to industry and CPA practices throughout the United States and Canada. She has authored, edited, and instructed courses in accounting, auditing, nonprofits, and governmental entities for PPC and other leading providers in the continuing professional education field. She has also been recognized as an "Outstanding Instructor" by the AICPA and numerous state CPA societies. She served as director of development for the AICPA and as accounting department/MBA chair for two universities. She has practice expertise in compliance auditing for nonprofit organizations, governmental entities, employee benefit plans, HUD, financial institutions, broker-dealers, CIRAs, and contractors. After graduating from the University of Michigan, she joined a national accounting firm, where she received extensive auditing experience with governmental agencies, Fortune 500 companies, and in business consulting.

Christopher K. Martin, CPA, Chris has worked with Checkpoint Learning 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 (Refer to executive summary)	
Program Description (Refer to executive summary)	
Instructional delivery method	Group Live
Recommended CPE credit	3.0 Credits
Recommended field of study(ies) (Refer to executive summary)	
Program Level	Update
Prerequisites (Circle One)	• Basic Accounting and Auditing professional experience
	• Basic Tax professional experience
	• Basic Governmental professional experience
Advance preparation	None required
Course registration and, where applicable, attendance requirements (1)	

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EXPERT ANALYSIS AND COMMENTARY

PART 1. ACCOUNTING

Did You Know? Making Sense of Recent Standards -- SSARS: Fraud and Noncompliance

Welcome to our first session on the A and A portion of this month's program. In today's rapidly evolving business environment, understanding and identifying potential fraud has become increasingly critical for accounting professionals. This session examines the essential requirements of SSARS 25 regarding fraud detection and regulatory compliance, while providing practical tools for conducting fraud interviews, utilizing analytical procedures, and recognizing key warning signs of fraudulent activity. Through analysis of fraud statistics, trends, and behavioral indicators, the discussion will equip professionals with effective procedures for identifying potential schemes and maintaining proper documentation and professional skepticism.

Now let's join Susan Longo, CPA, who will lead us through these critical aspects of fraud detection and assessment in today's accounting environment.

Ms. Longo

Hello, I'm Susan Longo. In this self-study course we're going to talk about fraud. We're going to talk about how it's committed, by whom, and some of the procedures that we could apply when we see certain red flags that might indicate that fraud is or noncompliance is, is present in a review engagement. We're going to spend a little time talking about schemes and scams for fraud and try to give you a little bit better detailed understanding of how this actually happens, as opposed to that sort of 50,000-foot level where you might have a basic team engagement discussion, but not get very far with what actually could be happening in your, in your client's books and records.

So, let's start with a fraud risk assessment, and SSARs does require a fraud risk assessment. Does it look like the risk, risk assessment in an audit engagement? No, but it does require that we have a risk assessment, an understanding of who, what, when, where and why fraud does occur.

So, a little bit of background that kind of gives you perspective. In the United States, on an annual basis, about $3.6 billion is lost through fraud. The average loss per case is almost $2,000,000, and 20% of the cases are well over $1,000,000. The target revenue, revenue, revenue, and when losses occur at a minimum 5% of revenue is lost to the company, and the United States ranks 5th in the world. So, we're not the worst, but we're certainly not anywhere where we should be. If we were to remove the fraud that occurs in government programs, then things would look a lot different.

So, whether you're talking about Healthcare fraud, Medicare, Medicaid and all the rest of that, sort of that, the healthcare programs, or we're looking at construction that is government funded or special emergency funding, like FEMA funding and like all the stuff that happened with COVID, including the payroll protection program, if we removed that, the statistics would look very different.

So, this is a, a set of questions that can help the conversation in a review in, in terms of, of the kind of major areas of focus. We all know we have financial statement-fraud and misappropriation, but we also have, have corruption. So, you know, starting at the lowest level, the misappropriation is theft, theft of cash, theft of inventory and fraudulent disbursements of all kinds.

The financial statement fraud are the timing differences as you push revenue and expenses from one period to another, the fictitious revenue, the concealed liabilities and expenses, the improper asset valuation, and you need to remember that that inappropriate disclosures are also considered to be fraud.

The corruption pace is the conflict of interest that often shows up as purchasing schemes and sales schemes, the bribery and kickbacks and the gratuities and the extortion and those sorts of things. So, we can start by making sure that everybody understands the types of things that can happen and then we can get into some more specifics.

Just to give you a, you know, a flavor, if we were to combine misappropriation and corruption, we've got 89% of the frauds accounted for. Now, 89% of the number of cases are accounted for, but not the dollars. So, the dollars are not in the misappropriation; the activity is. So, how do perpetrators keep concealed? Pretty easy; documentation, documentation and documentation. They either create it, delete it or manipulate it. It's all documentation. And the more likely that it's -- and I can, I can just tell you that, look, for instance, that I, I often help nonprofit organizations and especially nonprofit organizations that want to register with, with particular entities, government or otherwise. And I was helping a nonprofit get registered in the state where they want to operate, but they're not currently operating, and as soon as that registration was approved, they kept getting all kinds of official looking documents. "You need to post this, this federal requirement on the wall." "You need to, you need to sign up for this certificate and then be able to have that." And they, they all were official looking documents, but when you tested the addresses and the companies, not one of them was legitimate. Absolutely not one of them.

They had bought the registrations, and then they started dunning the nonprofit organization asking for $92.67 here and $62.43, and they just were dunning on them for all the stuff, and none of it was legitimate. And it's all about how you create the documentation and that is what is done. And you see it in your spam folders all the time, and so does the company.

The victim organizations, private companies are the biggest target. Now, the reason that it happens so frequently in private companies as opposed to public companies is that again, we're talking about the asset theft, and we're talking about the fact that it is the unsophisticated, ineffective internal controls that allow it to happen.

Management that allows this to happen by virtue of the fact that they don't want a lot of controls for themselves, and so therefore there aren't for everybody else, and management that doesn't focus on some of the basics of how to monitor employees, and if you don't have the reconciliations and monitoring going on and you're just, you're just an open target.

Again, size does make a difference. Less than 100 employees, that's where the, the larger losses are, and the lower levels of revenue, the larger percentage of the cases, smaller companies. Now, knowing that and knowing that in a review engagement you are supposed to focus on areas where there is a greater risk of material misstatement and a greater risk for fraud and noncompliance, we really need to look at the areas that have that kind of propensity because we want to spend time where it is in, in that it gives you the highest probability of actually encountering the red flags. So, corruption and billing frauds, the old revenue, and check payment and tampering, the disbursement stuff are the top three.

Now, interestingly enough, when you are a little bigger, and it is still the corruption and it is still the billing, but then what happens is the non-cash stuff, and that's strictly because a lot of, there's a lot more portable stuff. So, when you're, you're talking about the larger organizations, we can have the things that look like the inventory, that shrinkage that occurs. And when you're talking about a construction company, and there's a lot of stuff that goes, that gets lost, if you will, from work sites, and that's what happens with the, the larger entities.

So, what contributes to fraud more than anything else? The lack of internal monitor, and the ability of management operate pretty much the way they want to. Those are the two things. So, to the extent that you are in a review engagement, and you say to yourself, "Where might that happen," you have to define what is the focus for management. There are always targets where management spends most of their time and effort. If they were the sales-type, then that's where it is. If they were the manufacturing engineering-type, that's where it is. So, you need to know where management spends most of their time and therefore where there is a higher probability for the oversight.

But we don't tend to do that. Again, we, we tend to want to, to create this kind of global view of fraud, and it is not. You can't, the company's not vulnerable everywhere and management is not skilled enough everywhere and management doesn't have access everywhere, and lastly, the dollar return isn't everywhere. So, you need to understand where management would focus their efforts, so that you'd spend the time in the same places. Interestingly enough, but certainly one that fits a logical pattern, the higher up in the organization that you are, the more dollars you can extract through a fraud scheme and the longer you can perpetrate that scheme. So, it is important to see that relationship.

And generally, what happens is at the employee level, this is where you're getting the asset misappropriation, and once you get to the management level, this is where you're getting the financial statement level fraud.

Now, with the employees, you need to also recognize that there's a lot of turnover that happens, which is why the duration is fairly short-term. But what you need to also recognize is once you get to the manager and the owner executive level, if fraud and corruption and, and noncompliance is, is in the current period, it will have been in the prior period as well.

So, where there’s employee fraud you might be able to restrict your thoughts and actions in the review to the current period, once you get to the manager and the executive level it is multiyear issue. Where does it happen? Well, again, it makes sense that upper management has the largest dollar effect, but what should interest you is an understanding that the accounting department, and its related finance department, are where the other high dollars turns out to be.

So, and that should make sense by virtue of the fact that both of those departments have access to, to the records. So, can we give you a profile? Well, long-tenured employees steal more than, than three times more than anybody else. Why? Well, first of all, they have the knowledge and the access. Second of all, they tend to be in the background. They've always been there. They've always done what they've done. Nobody really thinks about it. Nobody really gives them a second thought.

So, not only can they perpetrate a more widespread fraud scheme, they can keep it going for a longer period of time. They are more likely to collude by virtue of the fact that they know where the skeletons are, and they know the other people that might be willing to do what they want to do.

Now, for long-tenured employees living beyond the means, close relationships to vendors and customers and financial problems are the key areas. Know your employees.

What happens all the time is that if you approach an employee that you know has a financial problem and talk to them, it doesn’t mean you're going to hash out some extra checks. It means that you are a sympathetic listener.

They generally will go somewhere else, because they've been there a long time and that's not what their normal mode would be. They didn't come in and get hired with the idea that, “Yeah, if we figure out that this is a good target, we'll go ahead and do it.” They did not come in with that. They've been along, around a long time., but the less tenured are twice as likely to have previously committed the fraud, and to have a criminal record, and the problem is small companies don't do the adequate background checks.

What's interesting about that profile that we gave you on this slide and the preceding, is we said absolutely nothing about gender, and it is correct. Put a male and a female in the same position, exactly the same environment, they have exactly the same probability of committing the fraud for exactly the same reasons. There is nothing related to fraud and, and gender. Now, what we do find is that males tend to commit a higher dollar fraud, has nothing to do with being a male. It has everything to do with they are in the upper management positions that give them the access. Again, it's, it's a position issue, not a gender issue.

So, again, the behavioral flags, the living beyond the means and the financial difficulties and they, that tends to be where we have the, and the close association with vendors and, and the customers.

All right. So, given that kind of background, what do we actually have to do in the SSARs engagement? So, the first thing is that we have to make some inquiry to determine whether there's any actual, suspected or alleged fraud and noncompliance. And we need to recognize that that all three are the basis of our inquiry, actual suspected or alleged, and it is fraud or noncompliance. And when we're talking about laws and regulations, please remember we're not saying that you are in a, a Yellow Book or single audit engagement or a broker-dealer engagement or anything like that. We're talking about the basic laws and regulations, contracts and agreements that govern business entities. So, things related to, to taxes of all kinds; property taxes, income taxes, payroll taxes, all of that, licenses, business licenses, professional licenses, all of those sorts of things. So, all kinds of contract arrangements. So, anything that is actual, alleged or suspected.

Now, the SSARs engagement says, "Okay. If you become aware of fraud or noncompliance, that it's either occurred, suspected, alleged, then what do you do?"

Well, the first thing is that you're going to communicate findings or suspicions to senior management and those charged with governance. That the issue always is, you know, "If I, if I recognize that fraud is often committed by management, reporting to management is reporting to, you know, the individual perpetrating the fraud, which gives them the opportunity to cover their tracks," so to speak. So, it is, it is important that you understand enough about the fraud to know whether management should be involved, or you have to go directly to the board. You do the same thing in terms of findings or suspicions of, of noncompliance with law and regulation. It is at that point a request that management assess the effects. It is not your requirement to, to determine the dollar loss for the fraud or noncompliance. Now, what you do do, then, is assess management's assessment.

So, management will tell you what they think might be the potential, and now you have to determine whether or not it's going to affect your conclusion and your report. In addition, there may be reports required to third parties which would require the accountant to make the appropriate communications.

All right. That's just your rules, but in order to, to actually do this, it's a risk assessment. The standard is very specific. You have to do a fraud risk assessment.

Now, the fraud risk assessment doesn't necessarily look exactly like an audit does, but remember, the fraud risk assessment in a review would require inquiry and require analytic procedures. So, both would happen. Well, in order to do that, I logically have to know, right, where's the risk that that might happen? We gave you some ideas. What could go wrong is where in the financial statements could that manipulation occur, and can I name it?

And one of the things that you have to recognize is that the documentation requirement is not sort of the generic, "I thought about the fraud stuff," but it really does want you to go and identify and document what could be happening in cash, receivables, inventory, property and that sort of thing, and I'm not sure that everybody spends an adequate amount of time doing that.

So, to sort of help with that process, I've given you some common fraud schemes and scams by financial statements area with an idea of understanding actually how it happens, where the red flags might be and what analytics and inquiries you might perform. So, it's not enough to just say, "Okay, I thought about it." What I need to be able to do is to document, all right, what my, my concern was that when I looked at cash, that they might be holding cash receipts open after the balance sheet date or closing cash disbursements records early.

And how could I just determine that? And it's looking for unusual deposit patterns and cancelled check patterns. It is not reconciling the bank. It is not reconciling the bank. That is not going to detect fraud. What is going to happen is I am looking for patterns. When do certain types of checks normally clear the back?

You know, this is best done, by the way, by looking at a proof of cash. That's the best fraud technique for that. If what you're worried about is that you've got some small operation that has a lot of cash going across the counter and there might be some theft of that cash, well, here's the symptoms and here's what we would look at in order to perform the increase in risk.

What we have is capital asset and is it a case of them actually stealing the stuff or using it when they, you know, it should not be for personal use, not removing assets that are sold, not writing down impaired assets, recording expenses as property equipment.

So, the issue is, what in a review should you actually be doing in terms of inquiries and analytics? And the intent is to give you a, you know, sort of a toolbox here that gets a lot more specific than the general conversation.

There's liabilities, misclassifying, failure to disclose, like debt covenants, unrecorded debt, failure to record contingent liabilities, and here are the analytics that you would do.

Payroll. Do we have pay -- this is, I'm sorry, this is payables. Payables. Do we have inflated vendor invoices? Do we have nonrecorded amounts?

Here's the payroll, goes to the payroll, and for small entities, we don't have enough employees that generally that that's a huge problem, depends upon how they are paying employees to know whether they could be diverting any of the monies. But again, for each of the schemes and scams, we have detection methods. So, the intent was to give you a basis for discussion.

So, remember what we're trying to do is we're trying to create fraud risk. When we have this, this type of, of understanding of what could actually happen and how it could happen, if you have the appropriate knowledge of the business and industry, it's easy for you to say, “No, in this particular case, that couldn't happen because,” and then you move on to the next one and the next one so that you, you are not doing what? You're not kind of trying to do the same thing for every single client. You're able to say, “Well, there's probably four or five places where that could happen.”

And so, we tried to give you some, you know, schemes and scams to help you focus that. You're required in the review to make inquiry, and that means the fraud inquiry as well and here, if you don't tell stories, you won't get very far. Asking somebody if they know of any fraud or suspected any fraud, you're going to get one of two responses. Indignant replies. “My employees are always honest,” or a blank look that says, “I have no idea.”

Now, neither one of those is probably an accurate view, so, you need to start with a story relevant to that particular client; some competitors, something in the news, something you remember from a prior client, something you remember from a prior year to get them thinking about how that actually happens, and then once you do, they start to contribute aspects to that story, and then out of that comes an understanding of, do they know where fraud would actually happen? Have they heard anything? Are they, are they aware of any allegations?

If you don't like doing things that way, then you, you always know the one or two people in the organization that knows everything that's going on, the receptionist, or you always know where the vulnerabilities are in terms of access.

So, Saturday morning with a pair of jeans, some Starbucks and some donuts on the back dock, you're going to find a lot of things coming across to it that you hadn't thought about and a lot of people willing to talk to you.

So, you want to know how the company spends time thinking about fraud, if they do it all, and do they have any programs and controls that address it?

Now, they may come around and say, “Absolutely not.” I mean, you know, you may start out by saying, you know, “Do you realize how vulnerable QuickBooks is,” and at that point, you're also going to get the blank stare. “Is it possible for QuickBooks accounts to be adjusted in a prior period and a prior year?” And when the answer is yes, now you begin to help them understand how vulnerable they may be. Are there -- is there anything that was reported? What do they have in place to prevent noncompliance with laws and regulations, like a Code of Conduct or that sort of thing? If there is anything unusual that happens, how does that get reported? How do they deal with related-party transactions and make sure that those are arm’s length debt market. So, there are some standard questions.

First of all, don't ask them in public. An employee won't tell you anything in public. If I were to ask you, “How do you think most companies find fraud?” I hope you don't say, “It's the accountant that's helping them do that.” Most fraud is found from a tip that comes from an employee. Now, it's not altruism on their part. They're either annoyed, they're not part of the scheme or they're disgusted with the fact that somebody else's it's stealing money and therefore either it's affecting what their potential bonus is, or compensation is or the viability of the company. So, there's no altruism in this at all.

So, if you know that, then you need a way to get that tip to occur. So, it’s recommended to talk to your employee, your, your client about setting up a hotline, and then you listen in to the responses, sorting through the, “He said/she said,” and “I don't like her,” and all that or, and, and “He's did this to me,” and all that sort of stuff. We can sort through all that out, but the hotline is the start is, is the start for understanding what happens.

And then when you do get to talk to people one-on-one, start with something that gets them going. You know, “What's it like to work here?” “Are you or anybody you know upset about what's happening around here?” “Have you seen somebody doing something?” And then you get into the particulars of, “How would somebody steal from the company, and how could they manipulate records and what would happen if they got caught,” and that sort of thing.

But you want to start with, you know, “Generally speaking, what's happening around here,” and get them to talk, and if they don't, just remind them there's the hotline and they can discuss what they want to on the hotline. Now, include in those questions some of the things that we know about the profile.

What was it? Financial difficulties, living beyond the means, unusually close relationship with vendors. So, let's talk about that. “Do you know anybody that's having financial difficulties?” “Do you know people that have long-standing relationship with customers and vendors, and could they actually enter false information?”

So, it's again getting people to talk about what's actually happening. And the best way is, again, to say, “Look, this happened to this company and they're very much like you. What's the chance it could happen here?” And if they say, “It can't,” then the question then follow-up question is, “Why not?”

For some people, they really haven't even thought about this. They haven't realized the risk at all of the probability that we could have fraud occurring, and it's, it's time they sort of thought about that. So, if I was going to conduct an interview with an employee, what might I do? Can I literally walk you through?

I would start out with, “Tell me something about yourself.” “How long have you been with the company?” “Have you had titles? “Have you had job responsibilities other than what you're doing right now? “What's your normal day like?” You know, “How do you, how do you stay organized?” And “When you're under pressure, what happens?” Because remember, fraud's going to occur when there's a gap. Somebody's going to take advantage of that gap.

So, if there is pressure at the end of a reporting period, for instance, and that employee has to generate a report, but in order to generate that report, they need information from somebody else, and that person is notorious for either not giving that information or what information is given, it's not accurate. What does that person do? That's what you want to know. Do they just wait? Do they go over there and try to encourage them and, and finally yell and scream at them to get it? Do they try on their own to generate what they think might be a fairly good number, or do they just make something up just to get the, the thing off the desk? You want to know under pressure how are they going to behave, because once you know that, you're going to know where you're vulnerable -- where they and the company is vulnerable for fraud.

So, whatever the task is, how they prioritize it and how do they deal with it when the, when there are deadlines. “Who covers responsibilities when you're out? Who moves the workflow through?”

Then sometimes when you get an explanation, you might want to verify it. You might say, “You know, I think I understand this. Why don't you go through it again,” or “Let me tell you what I understand and then correct me,” and you make sure when you say that, that you put something in there that's not correct, so that you make sure that they are consistent in what they're telling you.

“It doesn't make sense. The checks are signed without supporting documentation. Walk me through that again so I understand how that happens.” Find a way to make them again, reiterate what they told you. Make sure they're giving you a consistent answer, and to fill in gaps where you think we have gaps.

Ask them, “What worries you most about the company, about your job, about anything.” Ask them, are they, “Do they feel qualified to do what they're doing, and do they get the right kind of support for what they're doing?” And then move to, you know, are they, are they being asked to perform tasks that they're not qualified to do?

“Do you feel the work is adequately reviewed, that, that management actually looks at what you do?” And, and then then make it more global, that management actually reviews everybody. You know, are they under the thumb or, you know, everybody gets monitored, or nobody gets monitored? And “Are there things that are you, you would consider risky for the company?”

So, when you want to talk about fraud itself, you need to make sure that you define it for everybody, because if they don't know what you're talking about, so, that you make sure that you defuse the stuff that makes them defensive.

“We're not talking about a mistake, a mathematical mistake.” “We're not talking about some inadvertent error that you did.” “You didn't process something the way you were supposed to.” “You didn't sign off on something.” “You didn't do this, this, this.” Come up with all of your examples.

Fraud has an intent, and the intent is to remove assets from the company in something other than a legitimate transaction. So, where's the biggest risk for that can happen? Sometimes it's portable. You know, I can steal the wheel, the wheelbarrows, and sometimes it's financial. Then are there controls and policies that actually circumvent that?

And again, you need to define those, and the review and the documentation and the segregation are the three that you focus on, but you can also talk about, of course, you know, access controls and all that sort of thing, but are people monitoring? Are you required to have the appropriate documents before anything can, can be approved, and are the right people doing things? So, you want to, you want to define that for people.

Be persistent. You know, this is not a conversation that people like to have, but it doesn't mean you shouldn't have it. And everybody should realize that, that there's, there's fraud occurs as frequently inside a company as it now does with respect to anything, for instance, on the Internet. So, sometimes it's easy to start with that Internet example to say, “You know, were you ever hacked?” “Were you ever the victim of identity theft?” “Did you ever know anybody that was?” “Do you understand how certain things you do make you more vulnerable to that?” “Are you aware that, you know, it may be great that you have all these apps on your phone, including the access to your bank accounts, but do you realize how vulnerable you are, and what do you have in place to protect yourself?”

When you put it in the language that they can clearly understand, then when you start to talk about, “Well, how can that happen within the company,” they, they have a frame of reference.

It's always a story that goes from something that is relevant in their own lives before you start trying to have them try to design it and think about it for their own company.

You are required to do analytics because it is a review, and you can do the vertical or horizontal analysis, you know, the percentages of and the ratios and the cash-flow analysis and all that sort of works.

These are the types of ratios, and if you go back through those schemes and scams that I listed, you will find that most of these ratios are the relevant ratios that are mentioned for each of those scams, so utilize those. The diagnostic ratio of, ratio is just a basic understanding about how fraud occurs.

Most times fraudulent firms have negative cash flows. They have relatively higher cost of sales-to-sales, higher operating costs to total assets, higher PPE to total assets, lower receivables to total assets, higher related party transactions and lower working capital, and, of course, the most vulnerable are our small entities. So, it's, it's important to, to, to know the red flags because in a lot of cases what happens is we say, “Well, this client has never had fraud, so, therefore I, I can be pretty laissez faire about it,” and you never are going to be a victim until you're a victim.

I've also provided, going back to the schemes and scams and understanding of, if you see a particular relationship when you do your basic analytics, here is the potential for fraud. So, what happens with revenues, which is always a big issue? What happens with compensation? What happens with net income? What happens to inventory, with payables, with fixed assets and in each case there's potential for fraud. Operating expenses, debt-to-equity ratios. So, again, I tried to relate the inquiries in the analytics to the basic fraud schemes.

So, the process is: think about the risks of financial reporting, fraud and misappropriation of assets and where it resides in the financial statements, and that is a look at what you need to do for a review engagement.

Thank you very much. I hope you enjoyed the presentation.

A. Discussion Questions

1. Which of the following best describes the primary contributors to fraud within an organization?

   A. Lack of internal monitoring and management operating with little oversight
   B. Employee dissatisfaction and low wages
   C. Frequent turnover and hiring of new employees
   D. Excessive external audits and regulatory oversight

2. What is a required component of a fraud risk assessment in an SSARS review engagement?

   A. Full audit procedures including confirmation of account balances
   B. Inquiry and analytical procedures to assess fraud risks
   C. Randomized forensic testing of financial transactions
   D. Comprehensive internal control testing

3. Which of the following is considered a key behavioral red flag that may indicate fraud within an organization?

   A. Frequent employee complaints about workload
   B. Long-tenured employees living beyond their means
   C. Employees working extra hours without overtime pay
   D. A lack of communication between departments

B. Suggested Answers to Discussion Questions

1. The correct answer is A. Lack of internal monitoring and management operating with little oversight

   Fraud is most commonly enabled by weak internal controls, ineffective monitoring, and a management culture that either intentionally or unintentionally allows fraud to occur. This is especially true in smaller organizations where management has a high degree of control and oversight is limited.

2. The correct answer is B. Inquiry and analytical procedures to assess fraud risks.

   SSARS requires fraud risk assessment in a review engagement through inquiry (interviewing key personnel to identify any suspicions, allegations, or evidence of fraud) and analytical procedures (reviewing financial data to identify anomalies or red flags). Unlike an audit, a review does not require full substantive testing or internal control testing.

3. The correct answer is B. Long-tenured employees living beyond their means.

   One of the most common red flags for fraud is an employee, particularly one with long tenure and access to financial systems, who exhibits lifestyle changes inconsistent with their salary. Other key indicators include financial difficulties, unusually close relationships with vendors or customers, and reluctance to take time off (which may suggest they are concealing fraud).

PART 2. AUDITING

Initial Audit Engagements

Welcome to the second and final program section on the A&A portion of this month's program. For auditors taking on new client relationships, understanding the complexities and requirements of initial audit engagements is crucial for establishing a strong foundation. This comprehensive session examines the specific considerations, procedures, and best practices that auditors must navigate, including client acceptance procedures, communication with predecessor auditors, and risk assessment considerations unique to first-year engagements. The discussion provides practical approaches for evaluating client-specific risks, designing appropriate initial audit procedures, and establishing strong documentation practices from the outset.

Now let's join Chris Martin, CPA, who will lead us through this detailed examination of initial audit engagements.

Mr. Martin

Hi, my name is Chris. Welcome to today's presentation. Today we're going to be talking about Initial Audit Engagements.

So, congratulations to you, right? You've gotten a new client, right? I guess congratulations are in order. I know sometimes from my prior public accounting experience, you're like, “Oh, no, we've got another client,” right. So, at least hopefully you're looking forward with enthusiasm to servicing this new client, and you get to start fresh, right? You get to start with a brand-new client, starting to develop new business relationships and hopefully maybe doing it, quote/unquote, the right way.

So, today we're going to be talking about what GAAS requires anytime you get a new client, whether this is a client that has been audited before by another auditor or whether this may be is a client who has never been audited before. Maybe they've had compilation reviews, or maybe they've never had any of the professional kind of service actually provided to them on their financial statements in the past.

We'll be covering all the different requirements that you and your engagement team will need to make sure that you're aware of and that you implement during this first year of that new client engagement.

You see my background there on your screen right now. I actually worked at Arthur Andersen for most of my public accounting career, and I’ve had a lot of different experiences both inside of the accounting profession from public accounting experience and outside as a CFO and other types of consulting types of businesses as well.

So, I've had many opportunities to be both a brand-new audit client as well as an auditor of a brand- new audit client as well. So, I'll be experience, sharing some of my experience, some of my wisdom from all of those different experiences with you here today as well.

Okay. That being said, let's go ahead and jump into our topic today, Initial Audit Engagement. Okay. So, you see your learning objectives coming up on the screen right now. So, hopefully upon completion of today's presentation, you should be better able to, first of all, list the required and some of the more common audit procedures that you and your engagement team may be utilizing during this initial audit engagement.

We're also going to be talking about how we go about using a little bit more professional judgment in the evaluation of some of the more key risk assessment procedures that you might follow and some of maybe the client acceptance issues. Basically, some of the things that are, are required by Generally Accepted Auditing Standards to make sure that you and your firm have gone through the quality control measurement types of procedures to make sure that you are qualified to take on this particular engagement and that you really want to take on this engagement as well.

We'll also be determining the initial audit approach for some of the more common audit areas. So, when we start talking about some of these audit procedures and some of the different audit approaches that are out there, if you happen to be a subscriber to McGladrey or to PPC or to CCH, you'll also notice that those particular publishers of their methodologies have separate work programs for initial audits as well, and I'll be sharing a few of those with you here today and showing where you can find those, again, if you happen to be a subscriber.

I'll also be navigating out to Checkpoint shortly and I'll show you where you can find the audit standards and other publications that you can utilize as resources in case you have any particular questions or you need to do some further research after today's presentation as well.

Okay. So, we've got a lot of learning objectives there for our 100 minutes together, so let's go ahead and just jump right into the presentation itself.

Now, before I get into these particular items, I want to share with you just a real quick bonus slide. So, if you'd like to take a screenshot or something like that, you're welcome to, to obviously do that, but this particular graphic that you see on the screen now is what I refer to as the “hourglass.” And if you've taken any other Checkpoint Learning presentations from us, you probably have seen this graphic or something similar to it in one of those other presentations.

So, I like this particular graphic because from top to bottom, it basically is a quick synopsis of all the different GAAS requirements as you make your way from the beginning of an audit engagement all the way through to the end.

So, it's one of those particular graphics that you should probably commit to memory at some point, and at least share this with your other engagement team members, especially those that maybe you're training or you're supervising and you're helping them understand the big picture of what an audit is all about, and we're going to be focusing a lot of our time and attention today very upward, upward part of this particular graphic.

When we talk about client acceptance and continuance, we're talking about initial audit engagement. So, again, you've gone out and you've obtained a new client. Again, whether this happens to be a company that maybe has never had an audit before or maybe they've had other auditors and you happen to be what we call the “successor auditor” and you're taking over this particular audit engagement from a previous auditor.

Some of you may be the predecessor auditor, okay, and so there are actually some GAAS requirements that we'll be talking about here today for those of you who may be serving in that predecessor auditor role as well.

Once we then get into the, the top part of that hourglass, that risk assessment procedures, that top one third, we're going to be talking a little bit more about understanding the entity’s fraud increase, understanding internal controls and preliminary analytical review. All the things that we do in what we call “planning,” okay, especially for an initial audit engagement, a lot of additional attention on some of these opening balances and maybe even some of the consistency of the application of the, of the accounting principles that your client has adopted in the past to then make sure that the financial statements are going to be comparable to the other periods that may be presented. So, we'll be getting into several different areas.

Now, ultimately, we're going to take these risk assessment procedures, all of the information that we learn about our client. and we're going to feed it through the risk assessment process where we're going to have an engagement team meeting. We're going to brainstorm for risk material misstatement. We're going to be identifying certain significant transaction cycles, other types of risks and material misstatements so that ultimately, we are going to be in a good position to design those audit programs at the bottom, and then actually perform those particular procedures.

So, an initial audit is going to impact that design of the audit programs as well, because, again, we're going to have to determine how have we gotten happy with those opening balances, and what have we done as an engagement team to ensure that consistency of the application of those accounting principles that your client has adopted.

No matter what their financial reporting framework is, whether that's GAAP or a special purpose framework, again, those significant accounting policies and procedures that they follow have to be consistently applied throughout the different periods that are going to be presented. Otherwise, we might have a change in accounting standards or a change in accounting methodology, and obviously that's allowed by GAAS, right, but we have to have certain different disclosures that would be accompanying those to make sure that we explain that to the users of the financial statements.

So, let's jump back into our materials. And you see here I have included a list of all the different auditing standards that address initial audit engagements. And again, we're going to be going through most of these together here today, at least on a high level. Some we're going to delve into just a little bit deeper, but this is a great resource for you so that you can go back and do some further research on your own.

So, we see here Section 300 gets into how do you go about planning an initial audit engagement?

Section 228 is all about quality control for an engagement as conducted in accordance with GAAS.

Okay. So, again, how do we go through these acceptance and these continuous thought processes as a firm to make sure that this is a company that we want to take on as a client, and have we done our due diligence, to make sure that this is a client that we want to take on as well.

Section 210, all about the terms of the engagement. So, in that section they talk about, for example, all of your different engagement letters, and the standards are actually going to provide some illustrations and examples of various engagement letters that you might utilize.

Section 510 is all about audit evidence, and this is the section that's going to talk about those opening balances. How did we get happy with that opening inventory or opening plant property and equipment or any other opening balances of this particular client, especially because anytime that we have an opening balance, obviously that's going to have an impact on the current year's activity, right, especially for income statement types of items; right?

So, for example, plant, property, equipment, we're going to have depreciation expense over that particular period as well. Accounts receivable, we're going to be talking about bad debt expense. We're going to get into the discussion of revenues, inventories going to impact things like cost of goods sold. So, how do we make sure, again, that we're happy with those opening balances. And we're going to have several different illustrations and a lot of discussion on those particular items coming up here very shortly.

Section 700 is going to be any kind of report modifications that your engagement team will need to make when you're reporting on one of these initial engagements. So, Section 700, as you see here, is forming an opinion and reporting on financial statements, or maybe even more deeply.

Section 703, forming an opinion and reporting on financial statements of an employee benefit plan subject to ERISA, if you happen to be working on one of those types of audits.

And then Section 708, the consistency of the financial statements.

So, again, a great place for you to do additional research and a good reference tool to help you manage all of these different standards that are going to be impacting one of your initial audit engagements.

So, we see here on this particular slide, these are the broad responsibilities under professional standards regarding client acceptance, so, the very top of that hourglass that I shared with you just a moment ago.

So, your broad responsibilities under the professional standards regarding client acceptance decisions are as follows. The first thing that we're going to do is make sure that we have established policies and procedures. Now, we see here these come from the quality control standards, QM 10A.27. And essentially that particular standard tells us that a firm should establish policies and procedures for accepting and continuing client relationships and specific engagements. Engagement should only be continued or accepted when you and/or your firm, first of all, have the necessary competencies to perform that engagement, and you have the capabilities, including things like time and resources, to do so effectively, that you can comply with all the different legal and the relevant ethical requirements that are involved.

So, for example, are you independent, right, because you're taking on an assurance engagement, and you've considered the integrity of the client, and you don't have any information that would lead you to conclude that the client might lack integrity. So, if you question the client's integrity or their objectivity, you need to rethink the acceptance decision. Is this a client that you really want to go forth with? Are you going to be able to gain the necessary audit evidence that ultimately, you're going to need in order to be able to render an opinion that those financial statements are free of material misstatement. So, that kind of starts at step one.

Okay. Now, a lot of times that sounds a lot like the control environment of a particular company. So, an initial audit engagement, we're going to do a lot of additional work to help us gain some understanding of that control environment. Management's attitude about getting things right, management's integrity, management's objectivity, management's desire to have good financial statements and to get things right. Is management acting in an ethical way; right?

Typically, in a first-year engagement, we're not going to have a lot of information about that, right. So, we're kind of stepping out a little bit on a riskier limb in taking in one of these particular engagements, but we do want to spend a lot of time and a lot of effort in making sure that we feel comfortable with who this particular client actually is and who those management personnel are.

The second bullet point there, AU-C -- that should be a dash there, not a zero, so make sure you correct that in your notes. So, AU-C300 dot O6 and AU-C300 dot A8, the timing of the procedures. And those standards indicate that we should perform those client acceptance and continuous procedures, including evaluating the compliance with ethical requirements prior to performing any significant audit activities for this current year engagement. So, we want to make sure that we do this prior to getting started.

Item number 3, then establishing the preconditions for an audit. This is AU-C Section 210, and basically it addresses your responsibilities for agreeing on the terms of the audit engagement, and that includes establishing that certain preconditions are actually present. Now, I've got these preconditions on the next slide for you, so we'll be going through those in detail in just a moment.

The next item, then, communicating with the previous auditors, if there happened to be any. This is AU-C Section 210. Now, this section tells us that as the successor auditor in this particular case, you should request permission from this perspective client to inquire of their predecessor auditor or their predecessor auditors, okay, in plural, prior to the final acceptance of the engagement, okay. So, we have to make sure that we talk to the predecessor auditors before we formally accept the engagement, okay?

Now, we'll be learning why here in just a moment, but basically it assists you in making that acceptance decision. In determining whether or not you want to accept this engagement, you should evaluate the predecessor auditor’s response or consider the implication if the predecessor auditor provides no response or a limited response to certain of your particular inquiries. We also were going to have a real issue if our clients refuse to allow us to talk to those predecessor auditors. This would be one of those situations where you would turn the engagement down, okay.

Now, keeping in mind, okay, this makes just common sense, if you will, or at least professional sense that these client acceptance and continuous policies and procedures provide reasonable assurance that the engagements are accepted and that they can reasonably be expected to be completed with professional competence, and that the risks that are associated with providing those professional services in this particular circumstance would be appropriately considered.

Okay. All right. So, all of these different standards, again, built into that previous slide that get into the acceptance type of decision-making process. Now, here are those preconditions for an audit that have to exist before we would accept this particular engagement. So, as a precondition for any audit, right, whether again that's an acceptance of a new one or maybe even the continuation of a previous engagement, you should always determine whether the financial reporting framework to be applied in the preparation of these financial statements, is acceptable.

The applicable financial reporting framework is the set of accounting principles that's used by management, okay, the entity in this case, to prepare its financial statements. And obviously there are a lot of different financial reporting frameworks that your client can choose from, whether, again, that's GAAP or a special purpose framework. And so, there's a lot of different factors, and obviously we consult with our client again, to make sure that the framework that they're utilizing is acceptable.

So, you want to think about things like, you know, “What's the nature of the entity?” “What's the purpose of the financial statements?” You know, for example, do they meet the common financial statement information needs for a wide range of users?

Okay. Maybe they are, are to a particular user. Like for example, maybe there's a lender that's requiring the set of financial statements and you can use that debt agreement, okay, to help the client determine what's the appropriate financial reporting framework that they should be utilizing.

Sometimes laws or regulations are actually going to prescribe the applicable financial reporting framework. I've seen, for example, certain laws or certain regulatory requirements require a set of financial statements to be audited on the Generally Accepted Accounting Principles basis, right, on a GAAP basis.

Now, of course, this determination is generally made during those acceptance procedures. Now, luckily, okay, for all of us, we can typically presume, and again, this comes directly from that Standard, that you can presume that the applicable financial reporting framework is acceptable in circumstances in which the framework has been recognized as such by some relevant authoritative body. The Code of Professional Conduct, by the way, if you happen to read through that, actually describes and they delineate who these acceptable bodies happen to be.

The next one here, another precondition is to obtain the agreement of management that it acknowledges, and it understands its responsibilities, okay, and that agreement of course, is generally obtained through the use of an engagement letter. And most of you have probably seen an engagement letter before at some point in your career. And so, obviously we have to use an engagement letter for this first year audit, and if they have a few additional procedures and a few additional types of items that we want to make sure that our client agrees to, especially if they've never been audited before. It may even be very beneficial for us to sit down with those key audit people at our client and make sure they truly understand what this engagement letter is describing as a management responsibility so that they can feel comfortable accepting those responsibilities for themselves. The last one there, “Has management imposed any kind of limitations on the scope that might result in a disclaimer of opinion?”

Okay. So, AU-C Section 210 is the standard that we're looking at here, and that particular standard notes that there may be some circumstances when management or maybe even those charged with governance might impose a limitation on the scope of your work, and if you believe that the scope limitation would result in a disclaimer of opinion on the financial statements as a whole, you probably should not take on that engagement; right?

We're going to be disclaiming, so what's the point, right, of actually getting involved here with this particular client. However, if this particular entity is required by law or regulation to have an audit and the scope limitation and the disclosure of opinion is acceptable under that applicable law or regulation, then you may, but you're not required to, accept this particular engagement.

All right. Risk-based perspective. Just like any other audit that we're going to be working with, we want to make sure that we maintain this risk-based perspective, this professional skepticism that happens to be out there. So, when you're deciding to accept, okay, a new client, you consider the risks that are related to the engagement, of course. Now, this is a very high-level consideration at this particular point in time as to whether the risks that are related to the engagement itself and the overall financial statements might be greater than normal. And again, because this is an initial audit engagement, we're working with limited amounts of information, so, it's a little bit harder for us to get our hands around these particular risks.

For situations that propose, that pose, then, a greater than normal level of risks, your firm’s policies then would determine whether a new engagement would be declined or accepted. So, again, your firm’s policies and procedures are going to be really important in helping you make this particular decision.

Keep in mind, though, if a client with greater than normal risks is accepted, there has to be an appropriate audit response to the risk level in that audit plan, just like any other engagement. A client with greater than normal risks then poses a greater risk to you and your firm from a business risk perspective, and also involves a greater risk for pure misstatement to the financial statements. So, again, probably a riskier engagement, so, therefore, we're going to have to make sure that we do additional procedures to gather the evidence that we're going to need.

Again, as I mentioned a little bit earlier, we're probably going to do a little bit further investigation when we're looking at things like the control environment, and maybe even the internal control system itself, to make sure that the client again has integrity, objectivity. They want to get things right, and we're not identifying any overall risks, also known as “financial statement level risks,” that would cause us to then lower our materiality, maybe even to go back and rethink the acceptance for the continuous decision at the very beginning.

As I mentioned a little bit earlier, this particular standard then tells us for any new engagements, we should really obtain a general understanding of management's reputation, management's integrity, and taking a look at the client industry, their operations and their financial condition through things like maybe discussions with management, the predecessor auditors that may be involved or any other knowledgeable parties that you might have access to.

So, given that discussion, as you see here on the slide, the engagement acceptance decision normally focuses on factors that increase what we call “overall financial statement level risk.” For example, what's the intended use of the financial statements? Okay. If the financial statements, for example, are going to be used for the sale of the business and the sales price is dependent on these financial statement amounts, there's probably going to be a greater level of risk.

Through discussions with the predecessor auditors, the bankers, the attorneys or others raise any other questions about management's integrity. Are there increased risks due to things that may be indications of pressure or opportunities or incentives for things like fraudulent financial reporting on the part of management? Is the company in a precarious financial position that might create more of a likelihood of bankruptcy? So, we have to make sure that we're considering those going concern considerations that might be out there.

Now, consideration of this information might cause you to decline, to accept the engagement or might cause you to then plan and perform the audit in a different manner. We're just making ourselves smarter auditors here through all of this information gathering process.

Now, obviously we want to identify these different risks as early as we can in the engagement to give us and our personnel enough opportunity to really think through all the different risks to design a better audit plan itself.

So, before accepting, okay, as we just mentioned, you naturally want to consider the following items. Are there any professional reasons that we wouldn't want to provide these services to this client? What services are to be provided? Does the firm meet ethical requirements, including things, again, like independence? Do the professional standards and other relevant requirements, or are they able to be met in providing these particular services?

Now, obviously, after accepting a new client, consider whether your engagement acceptance procedures provide information that may be relevant in identifying those additional risks of a true misstatement due to error or fraud. This is just the standard saying, “Hey, as you're going out there and gathering all this information in order to accept the client, don't just throw that information away when you finally accept them.” That's a really good foundation of understanding the entity. Utilize all of those discussions and all of that information that you've been able to gather as part of the audit planning itself.

Now, as we're thinking about this perspective client's reputation, there's a few things that the standards tell us to make sure that we consider. So, you should consider the reputation of the prospective client, its management and those charged with governance.

Now, one of the characteristics of many smaller business entities is a concentration of ownership or operational control in maybe one or just a few individuals. This means that a primary consideration of client acceptance for these engagements is typically going to be the general honesty and the good faith of the owner or the primary manager or management personnel.

Consideration, therefore, can be given, for example, as to whether management and those that are charged with governance, are they knowledgeable about the business? Are they committed to the application of the appropriate accounting principles? Does the entity possess an appropriate organizational structure, including the nature and the purpose of things that may be related party relationships? Do management and those charged with governance, do they have an appropriate attitude about the financial reporting process, including internal controls? Do management and those charged with governance, do they reflect an appropriate attitude regarding the general nature of the audit procedures to be applied, the time commitments that they need to put forth, the client resources that they'll need to commit and the level of effort that's necessary, necessary to actually complete the audit?

Now, some sources of information about this perspective client’s reputation, okay. Now, obviously again, and again, these come down to some common sense or some “professional senses,” I like to call it, right, because there's not too much common sense out there it seems these days. But just keep in mind that neither the quality control standards nor generally accepted auditing standards provide any kind of specific requirements on the depth of your investigation of the predecessor auditor.

If that prospective client is well known to you, the only procedures might be, for example, an inquiry of that predecessor auditor and review of the prior financial statements and reports. Now, depending on your familiarity with the prospective client, the inquiry and analysis made before a client acceptance decision usually include things like the following: Specific inquiry of maybe former accountants or auditors who have provided services to this client. Specific inquiry of the client's lawyer and their banker. Review of the prospective client’s most recent interim and/or annual financial statements, including things like maybe tax returns and any other reports to regulatory agencies.

Finally, consideration of the composition, the qualifications and the autonomy of those that are charged with governance. What's their board charter, for example? Who do they report to? What's the structure of the organization?

Now, in addition, the following might also be considered when assessing the prospective client's reputation. Maybe think about management's response to suggestions that were made by that predecessor auditor for improvement to internal controls. Did they act on those? Did they do things like remediate certain deficiencies in their internal control? The inquiry of commercial credit agencies and business groups for association such as maybe the Better Business Bureau? A background check performed by an investigative firm. Now, the desirability of such a check might be suggested by indicators such as maybe frequent changes in auditors, bankers or lawyers, or maybe even the results of inquiries, reviews or considerations that were previously listed on this in the last several different slides.

Okay. Now, when considered necessary based on the circumstances, obviously a variety of different online databases and services are available to assist you in obtaining this information about the prospective client and its management. Those service providers provide your firm's ability to search for bankruptcy records, maybe litigation history done in Bradstreet reports, corporate filings, corporate affiliations, newspapers, trade publications containing information on the prospective clients and their management, okay. So, just make sure that we look at things like maybe even social media presence such as Facebook, LinkedIn, etcetera, and use all of that information early on in the engagement, again, to help you gather information not only about the client acceptance or continuous decision, but about gathering information that you can use for your risk assessment processes as well. And, again, all of this typically needs to be done before the acceptance or the final acceptance of this particular engagement. Now I've mentioned several times a communication with the predecessor auditor or auditors, and just know that it is required, okay.

Now AU-C Section 210, okay, tells us that we should ask specifically about the following matters. So, do we have, for example, any information that might bear on management's integrity? So, we want to think about things like are there, is there any identified or suspected fraud involving management, employees who have significant roles in internal control or maybe even others when the fraud resulted in a material misstatement to the financial statements. Also, we want to make sure that we talk about any kind of matters that involve noncompliance or maybe suspected noncompliance with various laws and/or regulations that this entity happens to be subjected to.

Now, you'll notice at the very bottom of this slide, the last bullet point there, AU-C 220.15 requires that your inquiries and the results of those inquiries be documented. So, your peer review is going to come in and look for specific documentation of those various items, and again, several of these various items happen to be required by the auditing standards. And again, here's just a few of those others that I happen to have just read to you about what those required questions would be, and again, make sure that those are properly documented in your workpapers.

Now, again, just like anything else that we learn about a client, we have to consider the results of those inquiries. Were there disagreements between the prospective client and/or the predecessor auditor over things like maybe accounting principles or different practices, financial statement disclosures or the audit scope itself? Maybe there's no clear reason for the cessation of that client relationship with the predecessor auditor. Have they provided us access to the predecessor auditor’s workpapers, okay, or has it been denied? Does the prospective client have had other CPAs that they've talked to and maybe they've been denied service by other CPA firms? We would want to make sure that we investigate those particular issues and suspected problems and risks as well.

We also want to assess the services. So, a preliminary discussion with that perspective client, obviously, is going to be necessary to become familiar with the services that are going to be provided. Now, this is going to allow you to consider whether the firm's resources are adequate to provide those services. It also provides an opportunity to make sure that the client understands the nature of the services to be provided, and any subsequent fee disputes then can be avoided if the client clearly understands that additional fees will be charged if additional services are later requested.

So, they may therefore be, for example, requesting a compilation when a review is actually required, or they're requesting a review when an audit actually is required. So, we want to get into the thought process and the discussion of those, whether we need to upgrade this level of service or maybe even downgrade it. They think they need an audit, but they really just need a review.

So, again, think about this with the client, talk it through, make sure that everybody understands, especially if there's a client that maybe doesn't have a level of sophistication in what public accounting services are all about. And oftentimes that might be an initial engagement with a brand-new company that has never been audited before. So, maybe they need some guidance and some help along with those particular items.

Now, I mentioned the independence several times. So, remember, we have to make sure that we consider our independence. So, we're going to refer back to the Code of Professional Conduct for our profession, right, the AICPA, and we have to make sure that we meet the independence standards, okay, not only with the AICPA, but as you see here in bullet point number 1, does any state boards, are they involved? Maybe the Securities Exchange Commission, the PCAOB review, the Department of Labor, the Governmental Accounting Accountability Office of the United States, each of those have their own independence rules. Now, luckily, they're very, very closely aligned, so, if you are in compliance with the AICPA's rules, most likely you're in compliance with the others as well, but you would want to make sure that you go through a few disclosure or a checklist or some other types of independence checklist to make sure that you meet all of those different requirements for the jurisdictions that you have to be independent within.

We also see here AU-C Section 200, overall objectives, the independence, honor and the conduct of an audit in accordance with GAAS requires you to be independent unless GAAS or law or regulation might specify otherwise. Okay. And again, remember the AICPA Independence Rules apply to engagements anytime we are working on an attest engagement, okay. So, the attest engagement is one that falls under the AU dash Cs, the audit regulations, or maybe even the SSARS, okay. The Statements on Standards for Accounting and Review Services, a compilation and a review, for example.

Now, meeting other professional standards or requirements that happen to be out there as well, okay. So, again, as I mentioned a little bit earlier, we have to make sure that we have the technical expertise and available resources, okay. This comes under the ethics standards ET1-30. It indicates that our firm should only undertake an engagement that can be reasonably expected to be completed with professional confidence.

So, before accepting a new engagement, we have to consider whether resources that are available to our firm are sufficient to meet the requirements of the engagement, things like the availability, the qualifications of our staff, the locations to be covered, any kind of specialized accounting or auditing skills or knowledge that would be needed.

Now, one of the things that the standard allows, it says you don't have to possess all of the skills and the knowledge that might be necessary to complete the audit before accepting the engagement, but you have to make sure that you obtain those before you finalize your audit engagement, okay. So, again, if necessary, you can always seek the assistance of other auditors or maybe on a, like on an agency or consulting basis, those are allowed.

Again, anytime you're going to be working with a third party, we have to make sure that we obtain client acceptance of those particular items and their consent, because we're going to be allowing these third parties access to confidential client information. So, again, we have to make sure that we consult with the appropriate client personnel, and typically get their consent in writing before we do so.

We also want to think about the condition of the financial reporting system. Is an audit actually feasible, okay. So, a company doesn't need a sophistic, a sophisticated financial reporting system with elaborate internal controls in order to be auditable. In fact, one of the characteristics often times of less complex entities, often times has limited segregation of duties, okay, because they have fewer personnel and limited functions within the financial reporting system.

Now, this usually precludes the degree of formalization of the accounting records and controls expected in a larger company; however, the financial reporting system, even of a small business, has to be sufficient to provide evidence to be able to support the transactions that have occurred, and then all of them that need to be recorded are in fact recorded. So, what kind of books and records do they keep? How far back can they go? Okay. Is it accessible information? So, again, is this company going to be able to provide the evidence that we're going to need outside of just inquiry alone, okay.

So, remember the audit evidence gathering procedures are inquiry, observation, inspection and reperformance. So, we have to be able to meet all of those various items in some kind of combination. Remember, the inquiry alone is never sufficient, that we have to be able to corroborate those. So, again, this is where that financial reporting system is going to be really important. Are there going to be documents that we can inspect, things that we can observe, whether that's an internal control or maybe being able to actually observe, maybe certain processes or certain procedures, or maybe even observe things like inventory, okay, depending again on where the company's inventory happens to be located, okay. And then lastly, are we able to reperform certain transactions, should we so desire to do so? So, for those reasons, you need to find out enough information about the financial reporting system to consider, again, whether that audit is feasible before you agree to do it.

The integrity and objectivity of management. Okay. We've talked about this just a little bit earlier, and we've talked about all the different ways that you can go about gathering that information, but again, we have to make sure that we meet this particular standard requirement to do so.

The use of those third-party service providers, I mentioned that again just a moment ago, just remember clients must be informed if your firm will outsource any of those professional services to a third-party service provider, and a contractual agreement between your firm and that service provider is going to be required to prevent the unauthorized release of that confidential information. You also, because you have to be independent, would need to make sure that that third-party service provider that you're bringing in, if applicable, is also independent of this particular client.

The next one there, adequacy of fees. “Hey, are we going to make money on this?” So, is the engagement actually worth pursuing or accepting? Okay. And a lot of us go, “Well, that's a silly question,” but you know what? A lot of firms take on clients that they're not going to make money on. And sometimes that's okay, right, because maybe that's going to get us an entry into a particular industry or it's going to give us the experience that we need to audit in a particular industry or, or, you know, different competencies that we might need in order to gather and obtain other clients that are similar to this particular one. So, there could be reasons, but we do want to think about the adequacy of the fees.

The last one there, any kind of specialized procedures, typically when work, using the work of another auditor, again, we want to make sure that we get the client's consent before we do that. We have to make sure that we still maintain responsibility for the work of those other auditors that maybe we consult with or that we bring on board to assist us with the procedures that we're going to be performing.

And then lastly here, and I mentioned just a little bit earlier, all of this has to be documented. It's recommended that you formally document this acceptance decision making process. And again, if you happen to be a subscriber to PPC or CCH or McGladrey, those different publishers of those methodologies actually have different continuance and acceptance forms that help you kind of go through the checklists of all the things that GAAS is going to require in order to make sure that all of that is appropriately documented. So, use those checklists if you have access to those particular items. I know that the AICPA, if you go to their particular website, they have various checklists that they publish as well. So, again, if you don't have access to those other methodology producers, maybe check with the AICPA to see what kind of resources are available to you and your firm as well.

That next bullet point, AU-C 220A dot 25, again requires you to document any issues that were identified concerning compliance with relevant ethical requirements and ultimately how they were resolved, if you were going to continue to accept this particular client. Obviously, if you withdraw, it doesn't matter. The conclusions on compliance with applicable independence requirements and any relevant discussion with the firm supporting those particular conclusions, and conclusions reached about the acceptance and continuing of the client relationship, and ultimately the engagement itself.

I mentioned this a little bit earlier but remember an engagement letter is going to be required, and an engagement letter is required on any of these attest engagements that we get involved with, okay. And we saw this a little bit earlier on that precondition slide, okay, that one of the preconditions is to obtain the agreement of management that they can acknowledge, okay, and they understand their responsibilities. And again, this particular agreement is generally obtained through the use of an engagement letter. Now, special planning considerations in an initial engagement. I've highlighted those for you here in the red area. So, take, pay particular attention to those various items.

So, we see here AU-C Section 300, okay, the risk assessment procedures that are out there. It provides guidance on considerations for planning an initial audit engagement. Now, since you typically will lack experience with this new client, additional planning procedures are generally going to be necessary in order to develop the audit strategy and your audit plan.

Now, the following matters are normally considered when beginning an initial audit engagement. The first one here, that first red bullet point, the nature and extent of the audit procedures that will be necessary to obtain sufficient appropriate audit evidence about the opening balances. I kind of alluded to that a little bit earlier, but here's where the auditing standards are getting involved and saying, “Hey, what have you done to gather evidence about those opening balances?” We're going to have a number of options available to us, and we'll be taking a look at those here in just a few minutes.

The nature and extent of audit procedures necessary to obtain reasonable assurance considering the consistency of application of accounting principles between the prior year and this year, any significant issues that were discussed with management and others during the auditor retention process, their impact on your audit strategy and your audit plan, and any communications that may be necessary with those charged with governance.

Now, remember, any time we have significant issues, whether those are significant risks or maybe significant auditing difficulties that we might anticipate or be experiencing, we have to make sure that we communicate those to the appropriate level of management or to those charged with governance as applicable, okay. So, make sure that we keep those various items in mind. Even if we're anticipating certain of those, we might want to go ahead and raise a red flag early on in the process to let them know that we kind of have an inkling, for example, that we might have a particular issue, and we just want to make sure that they're aware of what those issues are, and that we would keep them updated as we learn more and more pieces of information about those.

The next one there, arrangements regarding the review of the predecessor auditor's workpapers when applicable. So, typically if there is a predecessor auditor, we're going to want to review those workpapers. Why? Well, because it's going to be a source of good information for us. Right now we already know that we have to speak with those predecessor auditors and make certain inquiries before we can even accept the engagement formally, but once we have formally accepted that, we can then review their workpapers, if they will allow us to do so and if the client consents to allow us to do that as well, okay. So, again, we'll be making those arrangements and we'll be talking about that a little bit further in just a moment.

The next one there, the competence and experience of firm personnel that are necessary to respond to anticipated significant risks. And the last one there, any other procedures for initial audit engagements that are mandated by your firm's system of quality control, such as, for example, an engagement quality control, control review of the audit strategy or maybe even the reports that will ultimately be issued.

We'll find, for example, that a lot of times in an initial audit engagement, there might be some modifications to our auditor's report, especially, for example, if there's any kind of scope limitations. So, we want to make sure that we get our quality control group involved early on to help us through those different requirements as well.

Now, in the initial stages of an engagement, okay, you'll need to also do the following. First of all, we obtained that client's consent to review the predecessor auditor's workpapers and their files. Now, this can be covered when permission is obtained to communicate before acceptance as well, right? It doesn't have to be two separate communications, because remember, we're required to communicate before and after, okay.

We also then want to arrange the date, the location in the conditions for reviewing that predecessor auditor's workpapers. Now, for those of you who might be the predecessor auditor in this particular situation, just know that that successor auditor is going to be requesting that permission.

Now, some of the conditions might include the specific workpapers that can be copied and maybe even the availability of the predecessor engagement team members for discussion about various items. Now, the cooperation of the predecessor auditor is normally a professional courtesy; however, okay, there can be valid business reasons. Let's say for example, there's unpaid fees or maybe there's litigation that's going on, and those could cause that predecessor auditor to withhold the workpapers; however, okay, keep in mind withholding workpapers is not ethical if they contain information that is normally part of the client's accounting records.

So, if that predecessor is holding on to things like maybe invoices or shipping reports or any kind of accounting records that belong to the client, the ethical standards tell that auditor that they must return those client accounting records to that client, whether there's unpaid fees, whether it's litigation, etcetera, you still have to return their property to them. Now, you can withhold your working papers, you can withhold any kind of work products, right, like income tax returns or the financial status, etcetera, but you can't withhold the client's books and records.

All right. Now, let's talk a little bit more about those required opening balances and the evidence that we're going to be using for those. So, your objective, with respect to those opening balances in an initial audit engagement, including a reaudit, if that happens to be the case for you, are to obtain sufficient appropriate audit evidence about, first of all, whether there are any misstatements in the opening balances that might materially affect the financial mistake -- financial statements of the current period. Opening balances then reflect appropriate accounting policies that are consistently applied, or there's been some changes in policies that are appropriately now accounted for and adequately presented and disclosed in the financial statements of the current period.

Okay. Here's a real quick practical application question for you. Which of the following, then, do you think are not objectives with respect to those opening balances? So, you should obtain sufficient evidence about whether the opening balances contain misstatements that materially affect the current periods financial statements, depreciation, expenses the same as in the prior year or, C, appropriate accounting policies have been consistently applied. Which of these would not be the objective with respect to those opening balances?

Now, obviously, B is going to be the correct answer here; right? The fact that depreciation expense is the same as in the prior year might be indication that there's an error or fraud in that particular area, right, if it's exactly the same amount. But that is not going to be the objective with those opening balances. As we just discussed, remember, do those opening balances contain any kind of misstatements that might materially affect this current period financial statement, something that would be corrected in the current period?

Okay. So, for example, if your client had a cut-off error, right, and they recorded something either too early or too late at the end of the last accounting period, it's going to resolve itself in the current period. Does that create an error or fraud in this current period, or does that prior period need to possibly be restated, okay. And again, have those accounting policies been consistently applied from one period to the next, and if there has been a change, has that change been properly accounted for, and is it appropriately presented and disclosed in the current year financial statements?

Now, here's a couple of tables, okay, on this slide and the next couple that follow, okay, that are going to basically give you all of the AU-C references and the different requirements that are going to be present in the various auditing standards for these initial engagements. So, I want to go through these with you really quickly, okay.

Essentially, it's almost kind of a checklist for a work program, if you will, of all the things that we're going to be doing in one of these initial types of engagements. And again, make sure that you keep this in mind, maybe you print this one out and keep it very, very handy as a reference tool for all the different auditing standards that are going to impact these initial audit engagements.

So, we see here the requirements for the opening balances in initial audits and reaudits. We're going to read the most recent financial statements and the predecessor auditor's report for any information relevant to the opening balances, to the opening disclosures and for the consistency of those particular procedures from one period to the next.

We're going to request management then to authorize that predecessor auditor to allow us to review that predecessor auditor's audit documentation, and we're going to ask them to make sure that they request that that predecessor auditor fully responds to our inquiries.

If management authorizes the predecessor auditor to respond, then you're going to make certain inquiries of that predecessor auditor about matters that would assist you in making your engagement acceptance decision.

Okay. We're going to ask them, for example, are there any identified or suspected fraud involving management, any employees who have significant roles in internal control or others when the fraud might have resulted in a material misstatement of the financial statements themselves? Also, any matters involving noncompliance or suspected noncompliance with various laws or regulations.

Continuing on, we're then going to document those inquiries of the predecessor auditor and the results of those inquiries when the engagement has been accepted. We're going to obtain this sufficient appropriate evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. How? Well, we're going to determine whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, restated.

We're going to determine whether the opening balances reflect the application of the applicable accounting policies. We're going to evaluate whether audit procedures that are performed in the current period might also then provide evidence about the opening balances, and we're going to perform one or both of the following. When the prior period's financial statements were audited, we're going to review that predecessors audit documentation to obtain evidence about those opening balances.

So, for example, "Hey, you know what? They've audited plant property and equipment. Did they have any kind of audit adjustment? What kind of books and records does the client have? What did the prior auditor opine about plant, property and equipment? Are those ending balances of last year appropriate for the opening balances of the current period?"

We’re also going to see, as you see in the last bullet point there, perform specific audit procedures to obtain evidence about opening balances and the most recent financial statements and the predecessor’s report for any information relevant to opening balances, disclosures and consent.

Now, if we learn through all of that, that the opening balances contain misstatements that could materially affect the current period’s financial statements, we're going to perform some additional procedures to determine the effect, okay. If those misstatements exist, obviously communicate them to the appropriate level of management and those charged with governance. “Hey, management, there's a material error in the opening balances, okay? Let's figure out what we're going to do about it,” right?

If the prior period was audited by a predecessor, then we're going to follow the guidance in AU-C Section 510. 510 is all about audit evidence, okay, for those financial statements that were reported on by a predecessor that may require revision. “Hey, predecessor auditor, we have discovered some information where there might be a material misstatement in the set of financial statements that you audited.” Obviously, they would want to know that so that they can take action to get that properly corrected, including things like maybe reissuing their audit report or modifying their audit report that they had previously released.

We also are going to obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balance have been consistently applied, changes in accounting policies have been appropriately accounted for and adequately presented and disclosed. And then lastly there, if the predecessor's opinion was modified, evaluate the effect of that matter when you're assessing the risks of material misstatement of the current period’s financial statements. So, is that modification still appropriate? Is it going to affect maybe your risk identification and your risk assessment as well? Are you going to need to make the same or a similar type of modification this year as well?

Now, if the information obtained during the current audit indicates that the financial statements reported on a predecessor auditor may require that revision, then you're going to request management to inform that predecessor auditor, and then they're going to arrange for all three of you to the meet to discuss an attempt to resolve that matter. You also want to communicate to the predecessor auditor any information that they may need to meet their responsibilities for things like subsequently discovered facts.

If management refuses to inform that predecessor that the prior period financial statements may require revision, or if you're not satisfied with the resolution of that or those matters, then evaluate the implications for the current period audit and whether or not you would like to withdraw from the engagement, or if withdrawal is not possible under the applicable law or regulation, how you might then go about disclaiming an opinion on the current period financial statements.

Remember, we're not going to make any reference to the report or the work of the predecessor auditor as the basis, either in part or in whole, for the opinion on the financial statements, and if you're unable to obtain sufficient appropriate evidence about those opening balances, you're going to express a qualified opinion, or again maybe even disclaim an opinion on the financial statements.

Last slide, okay, of the summary of all the different auditing standards. If the opening balances do contain a misstatement that materially affects the current period's financial statements and the effect is not appropriately accounted for or disclosed, you're going to express a qualified opinion or an adverse opinion on the financial statements.

If the current period accounting policies are not consistently applied in relation to those opening balances or a change in accounting policies that they've actually implemented hasn't been appropriately accounted for or disclosed, again, we're going to express a qualified opinion or an adverse opinion on the financial statements. And lastly there, modify the opinion of the current period’s financial statements, if a modification of opinion in the predecessor auditor’s report remains relevant and it remains material to the current period.

Okay. So again, a pretty good synopsis of all of the different requirements related to an initial audit engagement. Let's look at, look at a few of these in a little bit more detail.

Now, the additional procedures in an initial audit engagement usually fall into one or more of the following categories: to obtain preliminary knowledge of the client, its business, its operating characteristics and its internal control, particularly its control environment and its financial reporting system. We discussed those a little bit more in depth earlier. To assess the reasonableness of the opening balances of significant balance sheet accounts, and then to obtain reasonable assurance of the accounting principles and their method of application in the prior year.

Remember, you should always read the most recent financial statements of the predecessor auditor’s report, if any, for information about opening balances, including disclosures, and again, about the consistency of application of accounting policies.

In an initial engagement, your objective is to obtain sufficient audit evidence about whether there are misstatements in those opening balances that might materially affect the financial statements of the current period. Normally, in most engagements there's no need for you to express an opinion on the opening balances. So, accordingly, the audit procedures applied to opening balances are usually more limited than the procedures applied to the closing balances of the current period.

Now, specific procedures that should be performed with respect to those opening balances include all of the following. I've got those summarized here for you on this slide. First of all, determine whether the prior period closing balances, again, have been properly carried forward to the current period, okay, or when appropriately have been restated.

Generally the auditor then would trace the opening balances in the current period general ledger to the prior period’s closing balances that support the financial statements to ensure that those balances again were properly carried forward. We do that all the time; right? We usually have our lead schedules, for example, that start with prior period, and we trace those to the prior period financial statements that were audited by us or audited by another auditor or, again, maybe we're auditing those particular items.

The next one here, we want to determine whether the opening balances reflect the application of the appropriate accounting policies.

The next one, evaluate whether the current period audit procedures provide evidence about those opening balances. We'll talk about that a little bit more here in just a moment.

Perform one or both the following, okay, any specific audit procedures directed at those opening balances that you feel are going to be necessary in your professional judgment, and again as we mentioned a little bit earlier, reviewing the predecessor auditor’s audit documentation to obtain specific audit evidence about those opening balances.

Now, according to AU-C Section 510, the nature and the extent of your audit procedures, okay, are going to depend on matters like the accounting policies that were followed, the significance of those opening balances relative to the current period financial statements, whether the prior period was audited, if so, whether the predecessor auditor issued a modified opinion, and the nature of the account balances, the classes of transactions and the disclosures and your risk assessment for the current periods on it.

Now, as I mentioned just a moment ago, we have the nature of these opening balances and, again, three different categories that we want to consider.

Focus on the opening balances that affect the current period’s ending balances or that affect the results of the operations for the current period, okay. The extent, again, of the additional procedures applied to the opening balance are going to depend on the extent to which the items in the opening balance are also in the closing balance and on the audit approach to that ending balance. Now this is especially true when the prior period financial statements weren't audited or you're not going to be using information from the review of the predecessor auditor’s audit documentation as evidence.

Generally, the account balances that you're concerned with are going to fall into one or more of the categories that I have for you on this slide. So, let's take a look at that first category first.

All or a balance, okay, or a substantial portion of that balance is accounted for by the opening balance, and the audit approach in the continuing engagement, then, is to focus on the items that they either increase or decrease the opening balance to substantiate the ending balance, okay.

So, for example, think about a roll-forward, okay, plant, property and equipment roll-forward, beginning balance plus additions, minus disposals equals ending balance. Oftentimes we focus on audit procedures on those things that increase or decrease that balance, so, those additions and those disposals.

Number 2, the second one in the middle there, all or a substantial portion of the ending balance is accounted for by the opening balance, and the audit approach then in the continuing engagement is to substantiate directly all, or most of the items in the ending balance. Think for example, investments in marketable securities, maybe notes receivable or maybe even notes payable.

The next category then, okay, Category C, the account balance turns over at least once during each accounting period and none of the items in the opening balance are normally going to be included in the ending balance, okay. So, in this particular category, think cash, maybe accounts receivable, inventory, accounts payable.

Naturally, then, the additional procedures are most extensive for the first category, and if you use information from the review of the predecessor auditor's workpapers as evidence, the use of that information as evidence normally is going to be considerable.

If the prior period was unaudited, you may obtain evidence about this category of opening balances by doing things like maybe examining accounting records and other information that underlies those opening balances, maybe things like, for example, vendor invoices, cash disbursement records, etcetera.

Your procedures are generally going to be the least extensive for the second category because the audit procedures applied to the ending balance, such as for example, maybe a confirmation, also support the opening balance.

For the last category, your primary concern is going to be the effect of the misstatement in the opening balance on the current period's operating results, because obviously it's going to resolve itself in the current period. So, audit evidence about this category of opening balances may be obtained from the procedures that you performed in the current audit.

For example, collection of opening accounts receivable balances during the current period is going to provide audit evidence about their existence, their rights and obligations, the completeness and the valuation at the beginning of the period. In the case of inventory, however, current period audit procedures generally provide little audit evidence about the opening balance. As a result, then additional audit procedures directed towards the opening balance of inventories generally and ordinarily will be necessary. I'm going to have a slide for you a little bit later that's going to talk specifically about that opening balance of inventory.

You may remember that one of the GAAS required tests of details is that the auditor needs to be present during the counting of the inventory, okay. Now, if you're not present, there are some alternative procedures that you can perform, but it's going to be of particular importance that you gather enough information and evidence to feel comfortable about that opening balance, otherwise, there typically is going to be a scope limitation for the cost of goods sold.

Now, obviously with the passage of time, certain opening balances are going to be more easily determinable. So, for example, after a year of the evaluation of accounts receivable, okay, obviously that's going to be more certain. The adequacy of year-end accruals and accounts payable, liabilities may be more easily evaluated after some time has passed.

Okay. So, what do we do if the opening balances are considered to be misstated? Okay. So, if we believe that the opening balances contain misstatements that could materially affect the current period's financial statements, you should perform some additional procedures to determine the effect of those misstatements on the current period's financial statements. If you do determine that the current period's financial statements are materially misstated, again, you should communicate those misstatements to the appropriate level of management and to those charged with governance. If the prior period's financial statements were audited, okay, you should ask management then to inform that predecessor auditor. And again, as we saw in that summary slide a little bit earlier, arrange for all three parties to discuss and attempt to resolve that matter.

If management refuses to inform the predecessor, that the prior period's financial statements may require revision, or, again, if you're not satisfied with the resolution of that matter, you should evaluate the implications for the current year audit, and whether or not you would like to withdraw from the engagement or possibly disclaim an opinion.

Any time we have that particular situation arise, obviously the recommendation is going to be to seek legal advice, as you make that evaluation. You should also communicate information to the predecessor that they may need to consider to meet their responsibilities for subsequently discovered facts.

All right, here's our next little practical application question. Which of the following do you think is not okay? A recommended procedure if you determine that the opening balances are materially misstated.

A, perform additional procedures to determine the effect on the current period's financial statements. B, ask management to inform the predecessor and arrange for all three parties to meet to resolve, or C, don't worry about it because it was audited by other auditors and you have no responsibility.

Okay. It would be nice if C was the correct answer, right, but since we're talking about which is not a recommended procedure, that would be C; right? You do have some responsibility. So, this is not going to be the correct answer. So, the other two are the recommended procedures that are there, as we just discussed over the last several slides.

Now we've talked about opening balances. Let's discuss consistency, just a little bit further. Now, the suggested additional audit procedures for an initial audit engagement include certain procedures designed to identify the accounting principles and the methods of application that were followed in the prior year to permit you to be able to evaluate whether there's been a change in those accounting policies. Usually there's no problem in identifying significant accounting principles, okay, things like inventory and depreciation methods, for example, however, you're also concerned with the methods of application.

So, for example, expense accounts included an overhead, the treatment of discount, the treatment of freight, for example. Also, you're concerned with the year-end closing routines that were followed at the end of the prior year and at the end of the current period because of the effect of current operating results. So, for example, things like maybe the dates, the methods of establishing cut-offs, for example. If accounting policies change during the current period, you should determine that the changes have been appropriately accounted for, and then, of course, adequately presented and disclosed in the current period's financial statements.

Now, there's very little guidance in the authoritative literature about procedures for determining the consistency of the application of the accounting policies for initial audits, unfortunately, right? So, in an initial, initial audit, you need to adopt procedures that you think are practicable and are reasonable in the circumstances that you're facing.

Achieving assurance as to the consistency is usually feasible when the client records are adequate, but if the client records are not adequate, you usually can't implicitly provide assurance on the consistency, and you may have some difficulty doing sufficient work on those beginning balances in order to be able to express an unmodified opinion on the current year's financial statements.

So, essentially, you only need to be concerned that accounting records are kept in sufficient detail to, again, permit determination of what accounting principles and accounting methods were used in the previous year to permit the, again, the application of certain auditing procedures to those opening balances. The extent of those procedures necessary, of course, depends on whether the engagement involves replacing the predecessor auditor or whether the client has never engaged auditors before. There's going to be a big difference between those.

Let's talk a little bit further about this predecessor auditor, okay. As we learned just a few minutes ago, AU-C Section 510 defines the term predecessor auditor as an auditor from a different audit firm who reported on the most recent audited financial statements, or, okay, maybe was engaged to perform but did not complete an audit of the financial statements. Now, that may include an auditor who was engaged to perform an initial audit but didn't complete it. It may also include an auditor who was engaged subsequent to the most recent audited financial statements who did not complete the audit. In the latter case then there may be more than one predecessor auditor. Maybe the one who reported on the most recent audited financial statements and the successor who ultimately did not complete the audit. So, we need to make sure that we have this inquiry of all predecessor auditors.

Now, as we saw just a few minutes ago, okay, anytime that we have this predecessor auditor, we're going to make sure that we get management involved. We make sure that they authorize that predecessor to allow us to review their audit documentation and to fully respond to our inquiries. As the predecessor auditor, you don't want to give out that confidential information to anyone without the consent of your client, okay.

So, again we want to address the following concerns: the consideration of that predecessor's independence, general competence, a review of their predecessor work auditor's workpapers overall and in detail for certain specific asset and liability accounts and consideration of the reporting options for the prior period's financial statements themselves, okay, and as we just saw, we want to consider their independence and their competence. So, again, your decision about whether to use information from a review of their workpapers as part of your risk assessment procedures, or maybe even as evidence about those opening balances, is going to be influenced by your evaluation of their independence and their competence. Although the predecessor auditor is not a component auditor as defined in AU-C Section 600, special considerations, that's the group audit standard, okay, even though they're not a component auditor, you may make inquiry similar to those that are listed in that section, AU-C Section 600. Okay. Now I've got those for you here listed on the slide. So, these come from AU-C Section 600, again, the group audit standards.

Now, inquiries about the professional reputation and standing of a component auditor, maybe made of the AICPA, the State Board of Accountancy by which that particular auditor happens to be licensed, the applicable state society of CPAs, or maybe even the local chapter, or in the case of an auditor from a foreign jurisdiction, the corresponding professional organization and if applicable, the PCAOB. You could obtain things like peer review reports, if available, on the predecessor auditor's firm as well, okay.

Now, obviously your understanding of a component or this predecessor auditor's professional confidence in this particular case may include whether that particular component auditor possesses an understanding of the auditing and other standards that would be applicable to this particular engagement, such as maybe US Generally Accepted Auditing Standards, okay, in a level that's sufficient to fulfill their responsibilities. Maybe they possess the special skills, for example, maybe some industry specific knowledge or knowledge that's relevant to the financial reporting requirements for the statements and schedules to be filed with regulatory agents that would be necessary again to perform the work on that financial information. And finally, when relevant, possess an understanding of the actual financial reporting framework that's, again, sufficient to fulfill their responsibilities. Remember that these inquiries are not required; however, unless the predecessor is well known to you, it may be prudent to find out about these particular matters.

The review of their audit documentation also provides information about their professional competence by demonstrating an adequate understanding and application of auditing and other relevant professional standards, and that the firm possessed the special skills that may have been necessary to perform that engagement.

Now, as we discussed just a little bit earlier, to obtain information to assist you in planning the audit is one of the primary purposes of reviewing that predecessor's workpapers. Information obtained from the review of their documentation, okay, as it makes sense, all right, it will assist you in developing your own audit strategy, helping you make planning decisions and developing your audit plan.

The review serves as risk assessment procedures for the current period's audit as well, and it provides information relating to the understanding of the entity and its environment. It helps you maybe identify additional risks, including those that may be related to fraud. It helps you identify control deficiencies, material misstatements, and significant auditing issues that were identified by that predecessor and any other matters that you think might be useful in helping you plan your current engagement.

If the predecessor's report, again, contains a modified opinion, you're going to want to evaluate the effect of that modification when assessing the risks of material misstatement in the current period as well. Obtain information to assist you in performing your audit, that is, obtaining information and evidence about those opening balances and the consistency of the accounting policies.

In all initial engagements, you're required to read the most recent financial statements, including the predecessor auditor's report, if any, again in order to obtain information about those opening balances, including disclosures and the consistency of those in application of those accounting policies and procedures. In addition, the review of the predecessor's audit documentation may be a source of audit documentation about those opening balances, as we learned just a few minutes ago.

Now, typically the predecessor is going to permit you to review audit documentation relating to things like planning, their risk assessment procedures, their further audit procedures, their audit results and other matters of continuing accounting and auditing significance, such as maybe an analysis of balance sheet account contingencies and the schedule of uncorrected misstatements. I always requested that of any predecessor auditors, in my particular circumstances.

Now, AU-C Section 510 does not require that predecessor to allow access to those listed workpapers, okay. The extent of access to the workpapers permitted is always going to be a matter of their professional judgment. There may be reasons that they don't want to grant access. And again, as I mentioned earlier, that could be pending litigation or maybe even unpaid fees; however, any limitation or denial would often affect your risk assessment, and the nature, timing and extent of the audit procedures related to those opening balances and the consistency of those principles in the current period audit.

Normally the predecessor's workpapers will be reviewed at their offices, okay, at a time that's convenient to them, okay. And I have found that the impressions gained merely by visiting their offices sometimes can be helpful in assessing their competency, okay. Are they organized? Do they have everything properly laid out, okay. Have they done a good job? Almost like going and reviewing a workpaper just like we would be reviewing our staff's workpapers, okay. So, you want to go prepared to do that. Let's talk about that just a little bit further.

Again, we just talked about the fact that we would review the predecessor's workpapers to gather evidence possibly about those opening balances and consistency. You see here the reference to AU-C 510, and it essentially tells us that audit evidence may include the most recent audited financial statements, the predecessor auditor's report thereon and the results of inquiry of the predecessor auditor. The results of the auditor's review of that predecessor auditor's documentation related to the most recently completed audit and audit procedures performed on the current period's transactions that may provide evidence about the opening balances or consistency, okay.

So, in other words, okay, the predecessor's workpapers alone do not constitute sufficient evidence. That's important to remember. Your review of their workpapers may affect the nature of timing, extent of your work related to those opening balances and consistency; however, the audit work performed, and the conclusions reached are solely your responsibility as the successor auditor.

Generally, your own procedures on opening balances will include things like scanning, following up on unusual items and evaluating whether the results of the audit test in the current year indicate possible problems with those opening balances. So, for example, do write-offs of receivables during the current period indicate maybe an inadequate opening balance for uncollectible accounts, okay.

Again, as another example, you might review the predecessor's workpapers, related things like maybe fixed assets and be satisfied with the predecessor's assessment of internal control, substantive test and evaluation of misstatements. Based on your review of the results of your procedures on current year transactions then, and maybe even the analytical procedures that you performed on accumulated depreciation, you might conclude that additional procedures on the prior year transactions are not considered necessary. So, as you can see, a lot of professional judgement comes into play here during all of this.

Now, the overall review of the predecessor's workpapers is intended to provide you with a basis for evaluating their general competence and adherence to GAAS. Some departures from professional standards or, or good practice, such as maybe a failure to use written audit programs, poorly organized or sloppily prepared workpapers, and their failure to obtain client and attorney representations or confirm receivables may be quickly noted. So, again you're looking to see were they're competent in the application of GAAS.

During the overall review you need to give particular attention to matters that might identify potential problems areas in your audit, okay. In particular circumstances, some or all of the different following procedures might be useful, okay. Read their planning memo. Read their other planning workpapers to assist you in identifying risks, significant audit areas and the nature of their procedures in those areas. Read their management letter or communication of internal control related matters, and client, maybe an attorney representation letter, to help you assess the condition of the financial reporting system and to identify any control deficiencies and/or maybe any unusual accounting or auditing risk that might be present.

Scan the workpaper summary of adjusting journal interest to provide an indication of the client's expectation on accounting assistance, and it helps you also identify any potential risks that might result in time consuming areas as well. So, where did they have audit adjustments? Where did they go over budget if they gave you access to their budget, okay. Scan the summary and the evaluation workpaper that accumulates any uncorrected misstatements. This is going to be a really important one because that's going to help you identify risky areas and possibly identify by uncorrected misstatements in those opening balances. Read their engagement summary memo to identify potential areas of the engagement and how the predecessor addressed those particular riskier areas. And finally, again, if they allow you access, scan their time budget, both planned and actual, to help you identify areas that required more than anticipated time, and again, those might also help you identify riskier areas as well. Remember, though, the predecessor may be sensitive about permitting review of the engagement summary memo and the planned and actual time budget. In that particular case, you may merely inquire about those areas that might have caused them difficulty or created additional audit problems for them.

Now we talked about an overall review. What about a more detailed review of specific workpapers themselves? If the overall review indicates basically a green light, okay, that, "Hey, you know what? Their workpapers are pretty good," right, you might be able to use that information in their audit documentation as audit evidence, okay. Then in that particular case you want to perform a more detailed review of those specific workpapers for specific asset and liability accounts.

So, approaches to the detailed review of their workpapers varies considerably in practice. Some auditors use the same checklist on supervision and review that they use in their own firm's practice and apply it to the predecessor's workpapers. That was always my approach, right? I might be reviewing their workpapers just like I'm reviewing my own staff's workpapers. So, I'm going to do an inquiry. I'm probably going to do some inspection, okay, possibly even some reperformance of certain of those particular procedures to make sure that they seem adequate. Some firms use specific special audit programs that are designed specifically for a detailed review of those specific workpapers, okay.

Now, we found, okay, that these approaches are oftentimes not particularly efficient for many engagements, those generalized reviews. You want to be very specific in what you're looking for and what you're looking to obtain. So, it's recommended that you scan the suggested audit procedures for an initial audit engagement for each specific account before you inspect the predecessor workpapers for that particular balance. And again, I'm making reference here to, for example, like PPC's workpapers for work programs for initial audit engagements. Look to see what they recommend and see if those were appropriate in the circumstances before you go out and review that predecessor auditor's workpapers. For some account balances, most or all those procedures can be accomplished in the predecessor's office. For other account balances, the procedures can be performed when you're applying procedures to the client's accounting records.

When the predecessor's workpapers will be needed for later application of auditing procedures, obviously, you're going to request copies of those particular workpapers as well. Now, this information is going to allow you, okay, to be the most effective and efficient when you're using those particular items as evidence for those particular account balances. Now, remember, it's important to avoid the tendency of making a detailed review of all the workpapers simply because they're available. After your review, you should prepare audit programs for the current year audit and include those additional procedures for those opening balances that you believe now are most appropriate in the circumstances.

Last couple of little topics here. Just remember we want to consider also our reporting options, okay. So, when a predecessor has audited the prior period's financial statements, they're going to be several different options in the presentation of the financial statements in the current period. The choice of options is going to affect the procedures that you're going to be applying, okay.

One option is to present only the current period's financial statements, okay, bullet point number one that you see there on the slide. Now, this approach doesn't change your responsibility in applying those audit procedures for the opening balances or for consistent application of accounting policies; however, it does avoid a number of problems that potentially might arise when the financial statements that are audited by a predecessor are also presented. So, for example, reissuance would require the predecessor to apply some additional procedures.

Also, even when reference is made, instead of reissuance, complications can arise if there are changes in the manner of presentation of the prior period's financial statements. So, for example, maybe there were changes in classification or the extent of aggregation of certain expense categories, for example; however, single period financial statements may not meet the client's needs, okay.

So, if comparative financial statements are presented, two of the alternatives are technically equally acceptable. The predecessor might reissue their report on the prior period's financial statement, or you as the successor may refer to that predecessor's report in the report on the current period's financial statements, okay. So, usually the simplest and least costly of these two alternatives for the client is for you to basically just refer to that predecessor's report. If the predecessor then reissues their report, they should apply several procedures, and the cost of the client is likely obviously going to be increased, okay.

AU-C Section 560, I've got there for you in the first asterisk, okay, essentially indicates that the predecessor auditor should read the financial statements for the current period, they should compare the prior period's financial statements that they had reported on with the financial statements to be presented for comparative purposes, and they should obtain a representation letter from you, the successor auditor, and management of their former client.

The purpose of that representation letter then from you is to determine whether your audit revealed any matters that might have a material effect on or require disclosure in the financial statement that was reported on by them. The representation letter from management addresses whether any prior management representations that they made might have changed, and whether any subsequent events have occurred which might have affected the prior period's financial statements. If a subsequently discovered fact then becomes known, they're obviously going to apply some procedures for any subsequent discovery of facts after their report release date, okay. Remember, if you as a successor, report on all periods presented, guidance for reaudits should be followed. So, basically, you're reauditing all of the PC periods and you're going to be reporting on all periods that were presented.

So, we talked a little bit earlier about using the predecessor's workpapers. What about the situations where there's no use of the predecessor's workpapers, okay? So, there may be no use of the predecessor's workpapers when you conclude, for example, that maybe the predecessor was incompetent or maybe there was an independence question about them. Also, the predecessor may not permit sometimes a review or copying of their workpapers and files because of, like we mentioned a little bit earlier, a fee dispute with the client or maybe because of pending litigation that has ensued. So, maybe the predecessor ceased operations and the workpapers aren't available, okay. So naturally you need to consider any increase in the audit risk that would result from that particular circumstance.

So, when no information from a review of the predecessor's audit documentation is used as audit evidence, your primary sources of evidential matter are the client's accounting records, okay, their documents that are in their possession and analytical procedures. In many cases, then, analytical procedures can be very effective in an initial engagement because of the passage of time. For example, and I mentioned this a little bit earlier, uncollectible accounts receivable in the opening balance are normally readily identifiable.

Usually in an initial engagement physical examination or confirmation of items in an opening balance are not going to be practical. A client might have obtained, maybe compiled or reviewed financial statements in prior periods. The accounting services may have been provided by your firm or maybe even another CPA firm. You're not required to communicate with a predecessor accountant who provided accounting services before you accept this initial audit engagement; however, as we mentioned a little bit earlier, it is usually worthwhile to communicate with a predecessor accountant and obtain copies of any detailed schedules for account balances that they may have in their possession, okay.

The initial audit procedures that should be applied to those opening balances are not going to be reviewed when there are previous accounting services; however, the same additional procedures for an initial audit engagement when information from a review of the predecessor's audit documentation will not be used as audit evidence for opening balances and consistency are still appropriate; however, consider, considerable time, for example, may be saved if you can obtain those detailed schedules from those workpapers.

Generally, the most time consuming and difficult audit engagements, on an initial audit engagement standpoint, is for an existing business that has had no previous accounting or auditing services performed. The additional procedures that should be applied to those opening balances are the same procedures that were referred to earlier for circumstances when information from a review of that predecessor auditor's documentation will not be used as evidence for those opening balances and consistency; however, there's an increased likelihood that the condition of the accounting records will not permit the application of those necessary procedures, okay. They've never been audited before. "Hey, did they maintain all of the adequate books and records that will allow you to obtain evidence about those opening balances?"

Remember, in an initial engagement, your primary concern with significant current asset balance sheet accounts is the effect on the current operating results. So, unless you can determine the reasonableness of those opening balances in these accounts, it will usually be necessary to disclaim an opinion on the results of operations, on the cash flows and consistency because of that scope limitation. Even though you do not express an opinion on consistency, the inability to evaluate whether there's been an accounting change is also considered the scope limitation in the standards.

Inventory is likely to present the greatest difficulty, but similar problems can arise with accounts receivable and accounts payable as well. Now let's talk about that one. A little bit earlier I made reference to this particular slide just a little bit earlier.

Remember, in some cases, you may not be able to observe the physical inventory on the balance sheet date. According to AU-C 501, okay, you may be able to obtain sufficient evidence regarding the existence of inventory at the balance sheet date by maybe performing some alternative procedures. In addition, alternative procedures will be necessary if the beginning inventory was not observed by a predecessor auditor, and you are giving an opinion on the current period's income statement.

Now, those alternative procedures include, but are not limited to, things like, for example, maybe observing the inventory at a subsequent date, okay, so you may be able to perform some test counts of the client's inventory on a subsequent date. Tests of transactions between the balance sheet date and the subsequent date then can be performed in order to reconcile those subsequent counts to the client's count at that balance sheet date, okay. Maybe we can review documentation of the client's count. Maybe we can review documentation at that balance sheet date. Maybe selected quantities then could be vouched from the inventory listing to the count sheets or the tags, and quantities for the count sheets or tags maybe can be traced to the inventory listing. These same procedures can be performed for the client's inventory count at the beginning of the period as well.

We could maybe perform things like maybe gross profit tests by maybe comparing cost of sales and sales for the last month of the prior period and the first month of the current period, okay, to determine if cut-off was reasonable at the beginning of the year. Maybe we could test prior and subsequent transactions as well.

So, again, there are a lot of different alternative procedures that are out there, but if you're not able to get happy with those, so, if you don't observe them or you're unable to satisfy yourself through these alternative procedures, then you're going to need to modify your audit report for this scope limitation. Now, you need to exercise caution when there's been no observation of the beginning inventories or no information from a review of the predecessor auditor's inventory observation workpapers can be used as audit evidence. So, again, if those balances are material, it may result in that scope limitation.

Let's take a look at our next practical application. Which of the following, again, is not one of the suggested alternative procedures? If an observation of the inventory was not performed, could we observe it at a subsequent date? Clerically test the inventory detail? Review documentation of the client's count. So, obviously we just mentioned, that is one of the procedures that we can perform. This one is. We probably do want to class -- clerically test their inventory detail, but it is not an alternative procedure that would give you enough audit evidence to feel comfortable about that opening balance. So, B is the correct answer here. It is not a suggested alternative procedure if the observation was not performed by you.

Last couple of slides here, and I've just got these here for real quick summary. So, let's say that there was a successor. You are reauditing the prior periods. We see here we request access to and review the predecessor's workpapers for the period under audit, okay, which is now considered the reauditperiod and the prior period that is going to be audited before this one; right.

We can't use the predecessor's workpapers as evidence. You should perform the procedures considered necessary to report on the financial statements as if they have never been audited. You can use information from your review for purposes of substantiating the beginning balances of the reaudit period and the evaluation of the consistency of the application of the accounting principles themselves, but remember, you're going to be performing all new audit procedures, and all of the evidence has to be evidence that you obtained, and you're going to be reporting as if you had audited everything from the beginning. So, basically, you're just reauditing all periods that are presented.

All right. So, that brings back, back to those learning objectives that we looked at from the very beginning. I hope that after this 100-minute presentation together, you now feel more comfortable with listing some of those required in the common audit procedures that you would utilize in an initial audit engagement. Remember, they're not difficult. You're really focusing in on the opening balances and the consistency, and you're using all of that information that you've been able to gather for the acceptance of this engagement, and from the review of that predecessor auditor's workpapers, if there is one, for not only the acceptance decision, but also for gathering information about those opening balances, and the consistency of the application of those accounting principles over the periods that are presented.

We can also now evaluate the key risk assessment and client acceptance issues that are, that are present, and we've talked about how we might determine the initial audit approach for some of those more common areas.

Okay. I want to say thank you again. I really appreciate you being here and I hope you enjoyed the presentation.

GROUP STUDY MATERIALS

A. Discussion Questions

1. When considering whether to accept a new audit client, which of the following factors is NOT a key consideration under Generally Accepted Auditing Standards (GAAS)?

   A. Management's integrity and ethical behavior
   B. The availability of the predecessor auditor's workpapers
   C. The company's industry and financial condition
   D. The company's willingness to pay higher audit fees for priority service

2. What is a primary objective when assessing opening balances in an initial audit engagement?

   A. To confirm that prior-year depreciation expense remains unchanged
   B. To ensure opening balances do not contain misstatements that could materially impact the current period
   C. To review all prior-year journal entries for consistency
   D. To obtain a signed representation letter from the prior auditor confirming their audit findings

3. Before accepting an audit engagement, what must a successor auditor do in relation to the predecessor auditor?

   A. Obtain permission from the client to communicate with the predecessor auditor
   B. Immediately request a copy of all prior-year audit workpapers
   C. Send a formal engagement letter to the predecessor auditor for approval
   D. Reaudit the prior-year financial statements before accepting the engagement

B. Suggested Answers to Discussion Questions

1. The correct answer is D. The company's willingness to pay higher audit fees for priority service.

   While audit fees are a practical business consideration, they are not a determining factor under GAAS for client acceptance. Auditors must assess a client's integrity, industry risks, financial condition, and available documentation (including predecessor auditor's workpapers) to determine if the engagement is appropriate and whether they can obtain sufficient audit evidence.

2. The correct answer is B. To ensure opening balances do not contain misstatements that could materially impact the current period.

   Opening balances are critical in an initial audit because errors or misstatements in these balances could carry over into the current period. The auditor must obtain sufficient and appropriate evidence that opening balances are correct and consistent with prior financial reporting principles. Simply reviewing journal entries or obtaining a representation letter does not fulfill this requirement.

3. The correct answer is A. Obtain permission from the client to communicate with the predecessor auditor.

   GAAS requires successor auditors to seek permission from the prospective client before engaging with the predecessor auditor. This communication helps assess any known integrity concerns, past disagreements over accounting policies, or audit scope limitations. Without this approval, the predecessor auditor cannot legally share information, as client confidentiality must be maintained.

SSARS—Refers to the Statements on Standards for Accounting and Review Services published by the American Institute of Certified Public Accountants.

Fraud—A violation is considered fraudulent if a material false statement, omission or act in connection with the transaction was committed knowingly, voluntarily and/or intentionally, as established by clear and convincing evidence.

Concealment—The cornerstone of fraud involves the hiding the actions which include committing offenses too small to be recognized as fraud by the victim.

Perpetrator—A person who perpetrates, or commits, an illegal, criminal, or evil act

Red Flags of Fraud—Red flags of fraud are factors or conditions that indicate that there is an increased likelihood that management fraud may be occurring. These include pressures on employees (or on the company itself) that could motivate them to commit a fraud and internal control weaknesses that provide employees the opportunity to commit a fraud. The presence of these red flags only indicates there is a higher probability that fraud exists in a company. There is no guarantee that a fraud actually exists. Management red flags of fraud may include such things as an overly complex business structure, including having several different auditing firms, legal counsels, and banks.

Predecessor Auditor—A predecessor auditor is an auditor who was previously the auditor of an entity and who has resigned or been replaced by another auditor. This person has the obligation to communicate with the successor auditor (at the successor's initiative). The predecessor auditor should make prompt and full response to specific and reasonable inquiries by the successor auditor regarding facts that bear on the integrity of management; on disagreements with management as to accounting principles, auditing procedures, and other similarly significant matters; and on the predecessor's understanding as to the reasons for the change of auditors (AU-C §210.11-.12). The predecessor auditor should customarily allow the successor auditor to review working papers. The predecessor auditor may be asked to reissue or revise the auditor report of the prior period.

Sufficient Audit Evidence—Sufficient relates to the amount and kind of audit evidence required by an auditor to form an opinion (i.e., Is there enough evidence?). (AU §326.20) Authoritative literature gives no guidelines or official standard for how much is enough; sufficiency of evidence depends on auditor judgment. Matters that affect this judgment are as follows: the nature of the item under examination, the materiality of the possible errors and fraud, the degree of risk involved (which depends on the adequacy of the internal control structure and the susceptibility of the item to conversion, manipulation, or misstatement), the competence of the evidential matter available. The test for sufficiency of evidential matter is whether the evidence can survive the scrutiny of other auditors or outsiders: Is there enough evidence to persuade someone else to reach the same conclusion? The sufficiency of evidential matter is restrained by the cost-benefit principle. The difficulty of obtaining the evidence, however, is not a valid basis for omitting the test.

Critical Accounting Policy—A critical accounting policy is generally a policy where the nature of the policies or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and the impact of the estimates and assumptions on financial condition or operating performance is material.

Qualified Opinion—An opinion that states that except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flow in conformity with GAAP; a qualified opinion is warranted when the matter is material enough to prevent an unqualified opinion but not sufficiently material to require an adverse opinion or disclaimer of opinion.

Workpapers—The schedules, analyses, transcripts, memoranda, and so forth, prepared or collected by an auditor while making an examination, and serving as a basis for his/her report.

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

1. What step should an accountant take if fraud is suspected in a review engagement?

   A. Communicate the findings to senior management or those charged with governance
   B. Immediately report to regulatory authorities.
   C. Investigate and determine the total monetary loss.
   D. Terminate the review engagement and inform the client.

2. What is one of the primary ways fraud schemes target nonprofit organizations?

   A. Mismanagement of restricted funds.
   B. Sending fake official-looking documents to extract money.
   C. Poor internal communications within the organization.
   D. Failure to monitor board member activities.

3. Which financial red flag is commonly associated with fraudulent organizations?

   A. Increasing receivables to total assets ratio.
   B. Stable or positive cash flows over time.
   C. Relatively higher cost of sales to sales ratio.
   D. A decline in related-party transactions.

4. Why is management's focus important in identifying potential fraud risks?

   A. It helps identify individuals with financial problems
   B. It determines the likelihood of reporting fraud to external authorities
   C. It reflects where most of the company's resources are allocated
   D. It highlights areas with the highest probability of oversight vulnerabilities

5. Which group is most likely to cause the largest monetary loss in fraud schemes?

   A. Temporary employees
   B. Entry-level employees
   C. Vendors working closely with companies
   D. Upper management with access to financial systems

Continued on next page

6. When reviewing a predecessor auditor's workpapers, what key information should the successor auditor focus on?

   A. The overall efficiency of the predecessor's audit procedures
   B. Material misstatements, significant risks, and accounting policies
   C. The time taken to complete each audit procedure
   D. Prior period revenue trends for future forecasting

7. Which of the following scenarios would most likely result in a scope limitation for an initial audit engagement?

   A. Management changes accounting policies with full disclosure
   B. The auditor is unable to obtain sufficient evidence regarding opening balances
   C. The client provides unaudited prior financial statements
   D. The auditor was not present for the inventory count and cannot perform alternative procedures

8. What should an auditor consider when assessing the feasibility of auditing a client's financial reporting system?

   A. Whether the system provides sufficient documentation to support transactions
   B. The client's willingness to increase its audit fee
   C. The complexity of the accounting software used by the client
   D. Whether the client follows a special-purpose reporting framework

9. Which of the following procedures is most important when assessing opening balances in an initial audit engagement?

   A. Confirming prior year revenue with external parties
   B. Reviewing board meeting minutes for past financial decisions
   C. Using analytical procedures to compare prior and current year balances
   D. Reviewing the predecessor auditor's workpapers and performing substantive tests

10. When determining whether to accept an initial audit engagement, what factor could indicate a higher level of risk?

    A. The client recently hired a new CFO with audit experience
    B. The client has a strong internal audit department
    C. The client's financial statements will be used for a business sale where the price depends on reported earnings
    D. The client has used the same accounting policies for several years

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11. What should an auditor do if they discover a material misstatement in the opening balances of an initial audit engagement?

    A. Ignore it if the misstatement was from a prior audit period
    B. Communicate the misstatement to management and those charged with governance
    C. Adjust the financial statements without informing management
    D. Withdraw from the engagement immediately

12. Why might an auditor be unable to rely on the predecessor auditor's workpapers?

    A. The predecessor auditor lacked independence or competence
    B. The client prefers not to share previous audit documentation
    C. The prior financial statements were issued under a different accounting framework
    D. The predecessor auditor did not perform a physical inventory count

13. What alternative procedure can an auditor perform if they were not present for the physical inventory count at year-end?

    A. Perform inventory counts at a later date and reconcile with year-end balances
    B. Rely on management's representation regarding the inventory balance
    C. Use industry benchmarks to estimate the client's inventory levels
    D. Omit inventory testing from the audit procedures

14. What reporting modification is required if an auditor cannot obtain sufficient evidence about the opening balances?

    A. Issue an unmodified opinion but include an emphasis-of-matter paragraph
    B. Express an adverse opinion on the financial statements
    C. Reference the predecessor auditor's report in the opinion
    D. Express a qualified or disclaimed opinion due to scope limitation

15. How can an auditor use analytical procedures to evaluate opening balances in an initial audit engagement?

    A. By comparing the client's financial statements to industry averages
    B. By reviewing internal controls over financial reporting
    C. By reconciling opening balances to prior-period bank statements
    D. By using trend analysis to compare prior and current period financial results

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