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CPE NETWORK
ACCOUNTING & AUDITING REPORT

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- How to Effectively Analyze and Implement a New Accounting Standard
- Sampling
- The Acts Discreditable Rule

EXECUTIVE SUMMARY

PART 1. ACCOUNTING

Personal Financial Statements................................. 3

Kurt Oestriecher, CPA, discusses personal financial statements, exploring their unique aspects, use, guidance, and presentation. *[Running time: 31:04]*

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

- Apply the measurement and disclosure requirements for personal financial statements under ASC 274
- Differentiate between estimated current value and fair value measurements
- Evaluate the appropriate level of CPA service for a personal financial statement engagement

PART 2. AUDITING

Gaining an Understanding of Internal Controls.... 20

Chris Martin, CPA, dives into the critical process of understanding internal controls as part of risk assessment procedures. *[Running time: 1:31:48]*

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

- Explain GAAS requirements to "understand" internal controls for a non-public entity
- Identify significant transaction cycles
- Brainstorm for risks of material misstatements and identify key controls
- Verify implementation of key internal controls
- Identify, communicate, and respond to design and/or verification deficiencies

ABOUT THE SPEAKERS

Kurt Oestriecher, CPA, is a CPA and partner with the accounting firm of Oestriecher and Company in Alexandria, Louisiana. He is in charge of accounting and auditing services, and is also involved in litigation support and small business consulting engagements. In addition to his client responsibilities, Kurt has served as a discussion leader for numerous accounting and auditing courses. He has served on the AICPA Accounting and Review Services Committee and is currently serving a three-year term on the AICPA Council.

Chris Martin, CPA, is a self-employed CPA who offers financial management, accounting, and education practitioner/consultant services to clients throughout the US and internationally in Bermuda and India. He has 30+ years in the accounting and accounting education professions, having worked with Checkpoint Learning since 2003. His public accounting career included such positions as senior manager at Andersen and as CFO for an SEC-registered communications company based in Atlanta.

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PART 1. ACCOUNTING

Personal Financial Statements

Personal financial statements provide insights into one's current financial condition, particularly in areas such as elder care planning, lending requirements, or personal financial planning. In today's session, we'll explore the unique aspects of personal financial statements, including their use, guidance, and presentation.

To guide us through this topic, we have Kurt Oestriecher, CPA and partner with Oestriecher and Company in Alexandria, Louisiana. Kurt is joined by CPE Network's Debi Grove Casey.

Ms. Grove Casey

Kurt, welcome to the program.

Mr. Oestriecher

Hello, Debi. Great to be here.

Ms. Grove Casey

So, today we want to talk about something that really is kind of unusual in the world of accounting because it's related to personal financial statements, and we don't usually talk about individuals as much as we do—unless they own businesses—as much as we do about companies and how they record things. So, to begin with, let's talk a little bit about the use of personal financial statements.

Mr. Oestriecher

And you're right, very rarely do people just walk in and say, "Hey, give me a personal financial statement," and understand for our firm, our demographics, my father founded our firm in 1971, and so he's had clients that were his age, you know, in the mid-80s, and children are becoming involved. And so when you talk about things like elder care planning for either estate planning or planning for the cost of elder care, we're seeing a lot of that within our client base.

Also, we have Oestriecher Financial Management Services, which is a completely separate legal company. When CPAs were allowed to start doing this type of work, we were always permitted to do this type of work, but we were prohibited from taking commissions until about 25 years ago. Well, how do you get compensated if you sell a financial product? That's just the way that industry pays. So more and more CPA firms have gotten into that, and so we successfully, we have Oestriecher Financial Management Services.

So from that standpoint, our clients are used to coming here to the same physical office where they're going on that side or this side and that's going to be part of personal financial planning. And then just from a lending perspective for whatever reason, banks are now requesting more personal financial statements. I don't know if it's an FDIC crackdown or just banks are looking at this maybe as interest rates are rising, uh, they're more concerned. I don't know the answer to that, but I've probably had more requests this past year than I've had in five years from clients that go to their bank and the bank says, "Okay, we just need you to fill out this personal financial statement," which is typically the American Banking Association's preprinted form. A lot of us have seen those. So we have that and then that's what we're seeing out there. And for my wife and I, I do a personal financial statement every year because I'm a nerd, we have financial goals.

And so … How do know if you're reaching your goals? Well, you do it. It's not about how much. I always tell people that to be financially successful, you have to meet your goals, whatever they might be. And for some people, they might look at me and say, "I hope y'all don't starve to death in retirement." Other people might look at us and say, "Wow, y'all saved a lot." It doesn't matter what other people think. And so if, and again, when I typically think of a family unit, and especially for the people we're talking about here, um, we are looking at a lot of times it's just a couple, because the kids are paid for and they're like, "Here's where we are now, how much more time do we have?" So many different uses for personal financial statements and we're just seeing more of them now.

Ms. Grove Casey

Let's talk about where the guidance is for personal financial statements when we go to create these.

Mr. Oestriecher

And then this is an interesting thing. And, and again, you're going to get a history lesson here. You might be bored as hell, but you might get a history lesson. But remember, we have this thing called Generally Accepted Accounting Principles—GAAP—and the reason we have this is people were writing financial statements long before the first written accounting standard existed. You know the answer to this, most people don't, but it's 1938 was when the Committee on Accounting Practices, the AICPA, wrote Accounting Research Bulletin 1 and put into writing what DuPonts and Rockefellers and everybody else had been doing. Well, eventually people started handing over pieces of paper to banks and said, "This is what I own. Forget about my business. This is what I own and this is what I owe," to kind of you let a bank or somebody know where you stood. The FASB, and again, you had the what? Committee on Accounting Practices, then you had the APB that issued opinions. Then you had the FAF, which created the FASB. None of those entities were concerned about persons and personal financial statements. All that GAAP has been written for business entities.

So the AICPA actually came up with the statement of position in the late '70s or early '80s—I want to say the early '80s, 1982, I believe—and that was the first written guidance we ever had on a personal financial statement, which varied greatly because for businesses, we had the historical cost concept. Well, for a 68-year-old person, it doesn't matter that they bought their house in 1947 for $13,000. What mattered in 1982 it's worth $185,000. So the AICPA had this statement of position. The FASB has actually never issued a standard or even an accounting standards update on personal financial statements. But, when they came up with their codification in 2008, they took all existing GAAP and AICPA statements of position were level-B GAAP. So that is how personal financial statements actually got into the FASB codification. They found a place for it. It's in Section 274. And it took all the concepts that had been in the AICPA statement of position.

So the guidance that we're going to talk about today has the exact same level of authority as if you're accounting for derivatives, the new—well, not the new—but the revenue recognition standard that's been around about 10 years now, the leases, it has that same level of authority. It was just never written by the FASB or voted on by the FASB, they just brought it in, and they brought it in as is, so we're gonna see how some terminology at the FASB ever decided, "You know what, let's take a look at section 274." I'll bet you they might make some changes, but as it is right now, this is where we are. So there is the highest level of authoritative guidance. You don't just get to put whatever you want to on there.

Ms. Grove Casey

So let's talk about what reporting entities can have personal financial statements, because it's not

Mr. Oestriecher

Right. And that, when you read Section 274, that's what I found interesting. I always thought it would be either an individual person or a married couple because we, the finances are so tied together, especially if you're in a community property state like I am. But actually it can be any, it can be maybe a multi-generational family stuff if there's family businesses. I've never seen one of those, but it can be an entire family. So typically it is the assets and liabilities of either a single person or a married couple. Now again, they just touch on this a little bit, but if, let's say I do live in a community property state like Louisiana, and this might come as a shock to you, but I have clients and friends that have been previously married that got remarried. And when they got remarried, they saw an attorney before they saw a spiritual leader, and they make sure the attorneys had everything separate.

In those cases, I don't think it's even appropriate to put the couple together because, while they're living their life together and they're married and they're happy and they maybe even have kids together, they have made the determination that what's one spouse's is not the other spouse's. So I think some judgment needs to be used, but there's nothing that prohibits you from presenting a married together. But I would probably add some sort of a footnote in those to say, “By the way, you know, there's a separate maintenance, separate property agreement,” or whatever, and then maybe even supplementary schedules to say, “Okay, we're reporting cash of X amount as much his property and as much as in her property.” So you need to look at that. And the other thing that when you're looking at just the Code itself and how we measure things, touched on this a little bit, it is estimated current value—it is not fair value. And I mentioned that from the standpoint of the FASB, how they might want to change some terminology on things, because if they said assets are listed at fair value, now within the Code, there is a fair value hierarchy: level one, level two, level three. And so what are level one items? Items where there is an active market for an identical asset. So right now, and I don't think anyone would ever do this, if they said, but we're not supposed to use fair value for personal financial statements, we use estimated current value. And by definition, estimated current value is the amount that the person, the individual or individuals who's presenting the personal financial statement, that they believe that it could be transacted between a willing buyer and seller, neither compelled to buy or sell. So because we're using the term “estimated current value,” and that is how you value assets and liabilities in a personal financial statement, it is inappropriate to solely use that fair value hierarchy.

Now, I think in most cases we will. In other words, if people own 100 shares of Exxon stock, if they used any methodology other than seeing what those 100 shares are sold out on the market on the date of their statement of financial position, I could probably challenge that. But level two items, that's when you have either active or inactive markets for identical or similar items, so there could be some things there. Let's say you own stock in a closely held bank in your community, that would be level two. But then level three, that's where you really, um—

Ms. Grove Casey

You're starting to go out on a limb.

Mr. Oestriecher

—might have to improve on it. Right. Because level three for fair value is just, okay, internal models. Well, the internal model that you're required to use in personal financial statements is just what you think it could be bought and sold for. And there could be some disparity there. Being from Louisiana, there's a home in Kentwood, Louisiana. It's a very small town. And there's a little ranch style home, one story, 2,000 square feet. And I think to get to the house, you literally have to turn off a paved road—I'm not sure, but probably it's kind of in the backwoods—and it's listed for over a million bucks. And why would anyone pay that? Well, it's Britney Spears's childhood home. So, there's something that attaches to that value versus just, hey, was just somebody owned by Mary and Joe Farmer or something.

So, that's where you can have some discrepancies because if I were to go ask every person in my neighborhood what their home was worth, they would probably be about 10-to-15% higher than what a real estate agent would actually list it for that they think they could get. So it is, we, we have to understand that with those definitions, when you're looking at who is the reporting entity, they're the ones that ultimately will determine whether or not or what they believe these amounts to be. And that's why some CPA firms don't like dealing with personal financial statements because, pretty much, a large portion of the things on the asset side are subject to estimate.

Now, obviously things like cash and marketable securities, and your 401k accounts, those can be tied down. But land, real estate, things like that, closely held businesses, which we'll talk about a little bit later on, those are very subjective. The debt side typically isn't subjective because estimated current amount is whatever the liability is, that's what you're going to have to pay to extinguish that liability. But that, that's why personal financial statements some CPA firms say there's just not enough risk. So very important on knowing who the reporting entity is because they ultimately are the ones that are be determining the value of some of those assets.

Ms. Grove Casey

Let's talk about the financial statements that are issued in a set of personal financial statements because they're not quite the same thing as a business entity.

Mr. Oestriecher

Right, we don't call it a balance sheet. We call it a statement of financial condition.

And it's not a classified statement. In other words, you just list items in the order of liquidity. So you're going to start with cash, then you're going to go into marketable securities, and somewhere in there you put your 401k. Just to give you an example of how there's some guidance that maybe could be updated. I know people, and I would be one of them, that when I was 40 years old, I could assure you I was going to sell my personal residence long before I would dip into my 401k. Because we were probably going to move again and I don't plan on dipping into my 401k until I'm 68 or 70 or I think RMDs now are 75 or whatever. So from a pure liquidity standpoint, my home is more liquid. But if I had to liquidate and I needed an emergency cash, again, I wouldn't do it. I would just go rob a bank before I get into my 401k, but—not really, I wouldn't rob a bank—but most people would just dip into their 401k. So it's not so much the liquidity on what your intent is, it is from a practical standpoint. So that's where most of your retirement accounts are listed and then you start getting into land, business, you know, closely held businesses, and things like that. So no classification. Now, this is where we get into a really tricky part. It's a closely held business. When you look at what is presented on the state and the financial condition, and what makes it tricky is for many people, this will be their single largest asset that they're going to have. And there's, fortunately, most people don't have—and I'll call it an unincorporated business, meaning most businesses are now either a corporation or an LLC, and how it's taxed doesn't matter, okay? But if you have a, if you ask your secretary of state permission to create an entity and you have, house your business in that entity, you don't, on your personal financial statement, list all the individual assets of that entity. You just simply put a value of X dollars.

Now, if I have an unincorporated business—and this is where the guidance was not terribly clear, let's say I have a lawn mowing business, let me use this very simple, okay?—and I have two trucks, two trailers, and I have two crews and the value of those trucks, trailers and the lawn mowers and everything is $65,000. Do I just list that, and let's say there's no debt, do I list that as a $65,000 asset of Kirk's Lawn Mowing Business? Or do I individually list those trucks in the trailers because they're titled in my personal name because I don't have an LLC. There's no specific guidance other than it says businesses should be shown as one item. So that's when I probably just put Kurt's Lawn Mowing Business, whatever the number is, $65,000, if I were to liquidate that business, that's when I could sell all those assets and liabilities or extinguish liabilities if there were any. And then this is where footnotes can sometimes be helpful if you want to separately list that out, especially if it's for banking purposes and they're lending specifically on those assets. But the unincorporated businesses is where sometimes people will say, "Hey, I'm going to list those assets separately." I have a client who does rental homes. And so he has an LLC, he has 24 rental units, let's say, and he buys and sells them. Well, again, we're just going to put the value of that one LLC. We're not going to put each of those 24 individual properties. But if he just decided to own them personally, which again, when you're renting, that's never a good idea—go consult your attorney—but if you were just gonna say, "Okay, I have, you know, Kurt's Rental Home Company," again, just for ease of presentation on the personal financial statement, you might wanna put that one number and then have supplementary information that individually lists those properties.

So that's the first challenge we have with closely held businesses. The second challenge we have with closely owned businesses is actually valuing them. And so a client comes in here, they have a business, it is a large asset, how do you value it? You might say, "Look, I want you to go get a business valuation." Sometimes we'll just use very basic valuation approaches where we will, you know, capitalize normalized earnings over a five-year period or something like that using a 20% discount rate and then add that to net book value of the business, of course then you have to adjust those assets for what you consider to be true estimated value. So, and if you think people may overvalue their homes, wait to see how much they may overvalue their businesses. Now when I say overvalue it doesn't mean they're wrong, okay? Because again estimated current value is the amount they believe it can be bought or sold. So . . . but that is where banks may come in or the users of the financial statement may adjust it. It is, it is a moving target. It is, some things on personal financial statements are not subjective. The cash you have in the bank account is not subjective. But the value of some things, especially closely held businesses, are subjective. Again, within reasonable boundaries, but they are subjective.

Ms. Grove Casey

Do you want to talk about the statement of changes and net worth?

Mr. Oestriecher

Yeah, that one we don't see very often at all. That's the equivalent of the income statement. And that's where you would have all of your income sources, then all of your expenditures, if you can get someone to classify their expenditures properly. And then you'd also have another line item for the change in those estimated current values. So if you value your home and the value of your business. Again, I rarely see that, but I do see in court proceedings sometimes. And this gets back to the elder care portion of it. We currently have an engagement. This might shock you, but an elderly couple, one of the spouses passed away, the other one having some cognitive issues. So one of the children invoked the power of attorney to kind of administer the affairs of the surviving parent. And some of the other children questioned whether or not they were doing it right. I know that probably never happens in your neck of the woods where families might start to fight and worry about how much they're going to inherit. I've got my personal thoughts on that. I'll keep them to myself here, but most people go,—

Ms. Grove Casey

Our demographics say that, yes, it probably happens quite regularly.

Mr. Oestriecher

—yeah, yeah, yeah. It gets happening and I always try to counsel people, “Let's keep our eye on the ball and take care of the parents first; whatever's left is yours.” But ultimately, once our firm got involved, the court said, “Okay, every six months,” because the siblings were asking for an accounting and it wasn't in a format they were looking for, and they go, “Well how do we know you're doing right?”

Now all sides are happy because every six months, with social security, rent from the properties, nursing home cost—I mean, it's just all right there, including that change in value. So that is a situation where we've used a statement of changes in net worth because it helps a family understand the expenditures because elder care is very costly. In fact, that's probably where we're going to see more uses of the statement of changes in net worth, especially where you have children that have moved away, and maybe everyone's kicking in to help take care of mom or dad and they want to see, “Okay where are those costs?” And rather than just an Excel spreadsheet coming from a CPA firm, gives a little more comfort because unfortunately we have seen children that take advantage of the parents’ estate a little bit and maybe paying their kids college tuition.

So it's something that maybe is coming more in vogue, but it is a useful statement in certain purposes. And the other change that you can have on there—and I should have mentioned this earlier when I was talking about the statement on financial condition, and it's a very unique thing that's in U.S. GAAP—after you list all those assets and liabilities, you have to come up with an estimated difference or estimated taxes on the differences between the fair value and the—or it should be the estimated current value—and tax bases of your assets.

So think of, if someone in their, you know, 52, they have $1.3 million in a 401k. Well, that looks nice on your income statement, but if all that goes to your—excuse me, statement of financial condition—but if all that, that's not part of your net worth, because if you liquidated that at below 59-and-a-half, depending on your tax bracket and what state you're in, half of that could wind up going to the government. If you're in the highest tax bracket, 30% going to the feds, you might have to, you have the 10% penalty and then 4-, 5-, or 6%. So you have to do that. For your residence, if you fall into the residential exclusion, well there's no taxes on that. So, within your statement of changes in net worth, that will be the last adjustment you will make is any change in that change in estimated taxes. And I mentioned earlier the American Banking Association personal financial statement form?

Ms. Grove Casey

Mm-hmm. Yeah.

Mr. Oestriecher

They actually don't have that number on there. And that's big because from a bank's perspective, when they're looking at it, they're going, “Okay, if I have to have this sucker—excuse me, *customer*—actually pay up and I have to liquidate stuff, I want to know how much it is,” because the government's going to get their money before the bank gets their money.

Ms. Grove Casey

Oh, they get it first. They always do.

Mr. Oestriecher

So that change, there's really three elements of your statement of changes in net worth. The actual income and expenses that went out, the changes in the fair value, and the changes in that estimated taxes that are going to be on your differences between your estimated current value and tax basis.

Ms. Grove Casey

But before we talk about the footnote disclosures, I think, I wonder how much of the "know your customer" right? Is playing a role when they ask for those personal financial statements when they never have before.

Mr. Oestriecher

That, that's a great question, Debi. I, I am much more comfortable doing this for a current long-term existing client of the firm than someone that just walks in the door. I'm not saying that I would refuse that type of an engagement, but I think I would spend more time on understanding why they need it. I might want to look at tax returns for the last two or three years just to say, "Okay, if they're reporting all these assets in Exxon stock, well, are you reporting dividends on your tax return?" And again, this is the level of service. I, I will tell you I would never audit or review a personal financial statement because it's really hard to get from an audit standpoint sufficient appropriate auditing.

Which you are permitted to, but your risk assessment would be through the roof. Because—and we do have ways to audit techniques for—you would just take the audit techniques for fair value and apply them to estimate a current value. So it can be done. My biggest issue is the completeness. What would you do to make sure they don't have any liabilities out there that haven't been reported? So that would be concerning. So from a compilation standpoint, we still have to—if we believe the information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory—then we have to maintain additional information and we saw this past year if anyone was paying attention—and this is not a political discussion; it's just because it was so high profile a lot of people became aware of it—but you might be aware that a former president of the United States was actually brought to trial in New York alleging that he had falsified his personal financial statement, which were compiled. And I think they kept that CPA on the stand for two days, ha, being grilled by both sides—neither side was happy. And the, and I was just thinking, "You know what, Kurt? There's a,—

Ms. Grove Casey

It sucks to be an independent accountant. Stay out of there!

Mr. Oestriecher

—don't get a politician!" If it's a politician or anyone that could be a, a, uh, political target, because I think it is fair to say that, that former president had that had never held political office, had no clue how complicated …it's my opinion. I don't think those charges ever would have been brought. So the more high-profile someone is or the more enemies that people have in powerful places, the more likely your risk profile is. But certainly I'd want to know the use of those personal financial statements. I'd want to know a little bit about the history of the person, um, before I would do that.

Ms. Grove Casey

Then, up your malpractice insurance. So let's talk about the footnote disclosures.

What kind of things are we looking at there? Because you mentioned already that the privately held entities, maybe we want to include a little bit more information in the footnote disclosures there as an example.

Mr. Oestriecher

Well, first of all, I think in most cases, again, CPAs are compiling these and just like for a regular business, you can management, in this case, the people, can elect to omit the disclosure. So usually you don't get these disclosures, but

Section 274 does delineate which disclosures are required. And quite frankly, especially when you're looking for elder care, some of these disclosures could give you the information you're looking for. So if you're just complying with the bank request, don't do disclosures. But if you're truly doing personal financial planning, or trying to help your parents understand something, it's worth looking at. Obviously, you define the entity presented, who are the family members presented. You disclose items or measure their fair values and any methodology for determining those major assets and how you did it.

If there are jointly held assets, so like my ownership in Oestriecher & Company CPAs, until this past year when dad passed away, was 50%, so I would disclose that. Now, most people will disclose that on the face of the financial statement. Even if they're omitting disclosures, if you own 25% of XYZG Company, you're going to put that, but you want the ownership percentage. Now we get into concentration. Some of those concepts that we have within a United States GAAP for businesses.

So let's say someone has worked in a union plant for however many years and they had stock options and it's great, they have $1.8 million in stock, but it's all with Bethlehem steel or something like that. So again, that, that's important information when you're doing personal financial planning because most people want to diversify. If you do have closely held business information related to that, if there's personal guarantee of debts of those businesses, that needs to be disclosed. Face amount of life insurance owned because your cash surrender value is what's going to be on the face of the financial statement. And by the way, when you talk about the clients, I'm just hitting my head within the last year, someone wanted a personal financial statement, and they wanted to put a million dollars for the life insurance because they had a million-dollar policy. I said, “No, it's not worth that.” He said, “Yeah, but it will be if I die.” I said, “And that's what you have to do for me to put that on a personal financial statement,—

Ms. Grove Casey

And you have to die.

Mr. Oestriecher

—first of all, no longer say Mr. and Mrs. Jones, it'll only say Mrs. Jones, then you'll have the million dollars. You have to die first. That's the contingency. And I don't think you want to do that.”

So, um, and then the other big one, and then this is, when you talk about overall personal financial planning, non-forfeitable rights for pensions. Some of the most under-, and it’s, you can't put it on there, but if someone were to determine the present value of expected future benefits from maybe a pension plan if you work for a state or local government, or social security, that is an asset that is very, very important. So someone like me that's been in the private sector, most of my retirement, of course, is in 401k plans and will show up on my personal financial statement.

With someone that has worked as a police officer or firefighter for the last 35 years, they're going to have a very nice income stream coming out and they will, maybe it will survive that person to his or her spouse, but you're not allowed to put the present value of those or expected present value of those. Isn't it interesting that a company has to put as a liability the present value of their future obligations, but the individual cannot put the expected present value of their future benefits? But that's just the way it is. But the footnote disclosures is where you would get that information. And so if you have someone nearing toward retirement age, that would be actually be a very critical footnote if you are applying for credit in the bank cycle, how would you be able to repay this loan?

So those are all the disclosures that are there and for certain tax disclosures, methodologies that are used.

Don't forget if you're doing a December 31st personal financial statement and you owe $18,000 on your 1040, well, that's a liability so you will further disclose those. Just like for businesses, if you have a long-term debt maturity, basically the same type of disclosures you have for businesses, you have for personal financial statements, but you don't have to schedule out the five-year principal payments. And then if there are commitments to purchase, build a home or any other kind of non-cancellable commitment, all those things need to be disclosed. So a lot of disclosures out there. And if you feel like some of them are useful, some of them aren’t, then go ahead and use that option that we have in compilations where you can, management has elected to omit substantially all disclosure, selected information presented. And then maybe you discuss just the life insurance, pension benefits, or things that would be very relevant to the known users of the financial statement.

Ms. Grove Casey

So let's talk about the types of reports. You mentioned before that you can audit, although you may not want to because of the ability to actually get that reasonable assurance that you want.

Mr. Oestriecher

I hit on that earlier, and so, um, you can do an audit or review. I do not recommend it.

The reason I don't recommend a review is, first of all, I don't even know what analytical procedures would be appropriate—I can't think of any—and you're already going to make inquiries in a compilation. So in, in a review, you do not have to get evidence to substantiate management's response to your inquiries. When I do a personal financial statement, the first thing I start is with the questionnaire and say, "Hey, will they give me these things?" So I'm going to basically do the same amount of work, so I'm more comfortable with the compilation. So I've never heard of actually reviewed financial statements.

But the one thing we need to worry about on compilation, or be concerned with, is if you do get a prescribed form like the American Banking Association, remember, they don't have the estimated taxes. They may want things measured differently. The disclosures that they have are going to be different from those GAAP disclosures. You have what we call a prescribed form. And so we used to actually have in SSARS, it was in section 300, a prescribed form compilation report. When SSARS 21 was issued and the ARC section was clarified, they got rid of that. So they eventually came back and put it in the guide. So if you have to get a preparation, compilation, and review guide, use that prescribed form report. Do not attach a GAAP report, compilation report, that is describing the financial statements is in accordance with GAAP if you're using a prescribed form because we have Section 274, there is GAAP, so . . . and you can also do a preparation engagement. Again, I don't recommend it because you're not attaching a report, but the client will say, "Hey, I'm giving this to a CPA," or, "A CPA did this," they might over-rely. I will only do personal financial statements using a compilation report—which, by the way, means you have to get an engagement letter—be familiar with Section ARC-80, that's compilations, and the umbrella you have, just as if it was a, a, you know, typical business that you're doing, you have to comply with everything in the compilation. That's what I would recommend.

Ms. Grove Casey

Well, thanks, Kurt.

Mr. Oestriecher

Okay, Debi.

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Personal Financial Statements

by Kurt Oestriecher, CPA

Introduction

Personal financial statements have long been used by lenders, advisors and others to evaluate the financial status of an individual for family for a myriad of purposes. The underlying standards originated in an AICPA Statement of Position, and when the GAAP Codification was adopted, the guidance in the Statement of Position was ASC Section 274. This course will provide updates on the proper measurement and presentation for personal financial statements.

Reporting Entity

The reporting entity can be an individual or married couple (note that the guidance in the FASB Codification has not been updated to include same sex marriage). It is the opinion of the author that this is an oversight and that the definition of married couples in ASC 274, which is defined as "husband and wife", should not be interpreted to eliminate same sex married couples from reporting both persons financial information in a single personal financial statement. A family can also be the reporting entity, though this type of entity is rarely used in financial reporting.

Financial Statements

Statement of Financial Condition

The primary measurement for assets and liabilities that are reported on the Statement of Financial Condition is estimated current value. While this is similar to fair value, the same definitions and conventions used to determine fair value for business and not-for-profit entities are not applied to estimated current value. Estimated current value is defined as:

> ***"****Estimated current value is the amount at which the item could be exchanged between a buyer and seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell****"***

While this definition will many times yield the same results as applying the definition of fair value, a reporting entity is not required to present all of the disclosures required for fair value since that term is not used in personal financial statements. As an example, if a business entity and an individual each owned stock in a publicly traded company that was was worth $150,000 on December 31, 20XX, both would report that value on their respective financial statements. However, the business would also have to disclose that this is a Level 1 fair value measurement and all of the other information required for fair value disclosures. The personal financial statement is not required to have such disclosures since estimated current value instead of fair value is used to determine the value of the asset.

All of the assets of the reporting entity shall be presented at fair value and in the order of liquidity and maturity. Typically, cash accounts and unqualified investments will be presented first, followed by qualified investments such as IRAs and the vested portion of 401K accounts. After highly liquid assets are presented, real property such as rental property, land, and a personal residence are then listed.

Ownership interests in closely-held companies are sometimes listed after real estate due to the fact that a person will often sell real estate before selling a closely-held company that is the primary source of income. If a business interest is a large portion of the total assets, the asset should be presented separately on the face of the Statement of Financial Condition and not "lumped together" with other financial investments.

Automobiles, personal property such as boat and recreational vehicles, along with home furnishings are often the last items listed.

Determining estimated current values can be time consuming, and in some cases, costly. Some of the more common sources of estimated current value for various assets are listed below.

Asset	Estimated Current Value Source
Residence	Comparable real estate listing Recent appraisal
Investment Real Estate	Comparable real estate listing Recent appraisal EBITDA capitalization
Closely-held company	Book value Book value adjusted for fair value of assets and liabilities Business valuation EBITDA capitalization **Note – the separate assets and liabilities of the closely-held company should not be reported on the Statement of Financial Condition**
Jewelry and furnishings	Cost (if purchased recently) Appraisal Reasonable insurance coverage Online resources
Automobiles, RV’s Boats	NADA value Other online resources
Life insurance policies	Cash value
Future value of retirement benefits	Items such as Social Security and payments from defined benefit plans are not allowed to be presented as an estimate of future benefits because those amounts are not available to the individual on demand as of the date of the financial statement

Liabilities are typically presented at the amount necessary to settle the debt and will usually not present any measurement difficulties. If material pre-payment penalties are due upon settlement of the debt, then the amount of penalty paid should be added to the debt. Ultimately, the Statement of Financial Condition is designed to indicate the amount of cash that would be available to the reporting entity if all assets were liquidated and liabilities paid as of the date of the Statement of Financial Condition.

In the event that the reporting individual has an interest in a joint venture, only the portion of the joint venture owned by the reporting individual should be included. If there is debt associated with the joint venture, only the portion of the debt that is allocable to the reporting individual should be included. However, if the reporting individual is an obligor on the entire amount of the debt, that fact should be disclosed.

The Statement of Financial Condition should include a provision for current federal or state taxes payable. If the date of the financial statement is December 31, the amount of refund or payable on the tax returns should be used. If the financial statements are an interim date, an estimate of the taxes receivable or payable should be calculated and presented.

Assets and liabilities should not be classified as current and non-current, but instead listed in order of liquidity.

An "estimated taxes on differences between estimated current value and the tax basis" should be calculated and presented after the total liabilities. This calculation is necessary in order to continue the overall objective of the personal financial statement of indicating the cash available to the reporting individual in the event of liquidation of all assets and settlement of liabilities as of a specific date. The following factors should be considered when calculating this tax estimate:

- Expected ordinary tax rates should be used for bonuses receivable or any other asset that would be considered ordinary income if received as of the date of the Statement of Financial Condition. The most common assets that would be ordinary income is a distribution from a retirement account and certain deprecation recapture.
- Capital gain rates should be used for all assets that are subject to capital gains.
- Alternative minimum tax should be considered if the taxpayer is either typically subject to alternative minimum tax or the liquidation of all assets would increase income to now trigger the alternative minimum tax.
- The net investment income tax should be considered for capital gains if the taxpayer is above or would be above the NIIT threshold on liquidation.
- If the taxpayer is under age 591/2, the early distribution penalty should be calculated for retirement distributions unless an exception would apply.

Net worth is calculated as the residual of assets less liabilities and estimated taxes on the differences between estimated current value and tax basis.

On the following page is an example of a Statement of Financial Condition.

James and Jane Person
Statement of Financial Condition
12/31/20XX

Assets

Cash	$ 145,000
Mutual funds	50,000
Retirement plans	1,200,000
Stock - Company ABC - 50% ownership	500,000
Land LLC, Partnership (50%)	250,000
Investment, LLC (50%)	250,000
Residence	450,000
Recreational vehicle	250,000
Vehicles	80,000
Total assets	$ 3,175,000

Liabilities and Net Worth

Income taxes payable	$ 2,000
Mortgage Payable	150,000
Note payable - vehicle	10,200
Note payable - vehicle	51,500
Note payable RV	85,000
Total liabilities	296,700
Estimated taxes on the differences between the estimated current value of assets and the estimated current values of liabilities and their tax bases	780,000
Net worth	2,098,300
Total liabilities and net worth	$ 3,175,000

Statement of Changes in Net Worth

A statement of changes in net worth is usually not presented as most users of personal financial statements are more concerned with net worth. Other documents such as income tax returns or financial statements of closely held business are used to provide relevant information related to income. From a practical standpoint, most people do not maintain sufficient detail of personal financial transactions throughout the year, therefore obtaining the information can be costly. The sections of the Statement of Changes in Net Worth as are follows:

Realized increases in net worth

The reporting entity will include all income received in the form of cash or other liquidating compensation. Common elements of this section include:

- Salary and other forms of income from employment
- Investment income – dividends and interest
- Distributions from closely held investments
- Gains on sales of assets

Realized decreases in net worth

- Personal expenditures
- Income and real estate taxes
- Interest expense

Unrealized increases in net worth

- Unrealized gains on marketable equity and debt securities
- Decrease in estimated taxes on estimated current values of assets and liabilities
- Increases in qualified retirement accounts
- Other increases in estimated current values of assets or liabilities

Unrealized decreases in net worth

- Increase in estimated taxes on estimated current value of assets and liabilities
- Unrealized losses on gains in marketable equity and debt securities
- Decreases in qualified retirement accounts
- Other decreases in estimated current values of assets or liabilities

In order to properly prepare a statement of changes in net worth, all realized transactions should be recorded in a general ledger using the broad categories suggested above. Journal entries should be used to adjust assets and liabilities to fair values. The entries will typically be presented in the unrealized increases and unrealized decreases section of the financial statement.

Disclosures

ASC 274 provides guidance on on disclosures for personal financial statements. While many personal financial statements will be presented in the form of compiled financial statements that omit substantially all disclosures, the following disclosures should be presented on audited, reviewed, or other presentations that do not omit substantially all disclosures.

- The entity for which the financial information is presented
- Accounting policy that assets and liabilities are measured at estimated current value
- Methods used in determining the estimated current value of major assets and any changes to such methods
- Nature and ownership percentage of jointly held assets
- Major concentrations of investment portfolios
- Relevant information for closely held investments
- Description of any intangible assets and the estimated useful life
- Face amount of life insurance owned
- Nonforfeitable rights such as pensions
- Methods used for determining the estimated taxes, both current and estimated taxes on differences between estimated current value and tax bases
- Unused operating losses, capital gains losses, and other suspended losses
- Maturities of debt, interest rate and collateral
- Noncancellable commitments

While not required, the face of the financial statements will often contain cross-references to any footnote disclosure that provides information related to that asset or liability. For example, if a mortgage obligation is on the Statement of Financial Condition, and note reference such as (Note X) may be placed on the line item for the mortgage obligation to alert the user to the additional disclosure.

Levels of service provide by a CPA

AICPA standards permit the issuance of audit, review, or compilation reports with respect to a personal financial statement. An accountant may also perform a preparation engagement with respect to a personal financial statement. All ethics requirements, including independence, must be adhered to in the performance of any engagement. Therefore, any relative of the CPA should be evaluated to determine if an independence impair exists. If there is an impairment, an audit and review is prohibited. A compilation may be performed, but the lack of independence must be disclosed.

Audits

While it is permissible to perform an audit, many firms will not perform such an engagement. The completion assertion creates a high inherent risk as most individuals do not maintain a set of books. There is also high inherent risk on many of the assets that are presented at estimated current value.

Reviews

Because review procedures are substantially less in scope than an audit, this is the preferred engagement when a user requires some level of assurance. An accountant would rely much more on inquiries as there are not many analytical procedures that would provide review evidence other than a comparison with prior periods.

Compilations

By far the most common engagement, and for many firms the only type of engagement, performed on personal financial statements. The accountant uses the same standards, AR-C 80, that are used in a compilation of for-profit, not-for-profit, or governmental entity. Therefore, an engagement letter is required and other compilation procedures are required.

Summary

CPA's in public practice are often to assist clients in preparing and presenting personal financial statements for banking, borrowing, and other purposes. The CPA should be familiar with how to present the personal financial statements in accordance with GAAP and choose the appropriate level of reporting based on the needs of the client and user.

GROUP STUDY MATERIALS

A. Discussion Questions

1. What is the primary difference between 'estimated current value' used in personal financial statements and 'fair value' used in business financial statements, and why might this distinction be important?

2. Why is it important to present assets in the order of liquidity and maturity on a Statement of Financial Condition, and how might this affect the user's understanding of the financial statement?

3. What are the different levels of service that a CPA can provide in relation to personal financial statements, and under what circumstances might a CPA choose to perform a compilation rather than an audit or review?

B. Suggested Answers to Discussion Questions

1. The primary difference between 'estimated current value' and 'fair value' lies in the application and required disclosures. Estimated current value is defined as the amount at which an asset could be exchanged between a well-informed and willing buyer and seller, without the necessity to include the disclosures required under fair value measurements for business financial statements. While fair value is often more rigorously defined and requires detailed disclosures, estimated current value in personal financial statements does not require the same level of disclosure, making the preparation less complex in certain areas.

2. Presenting assets in the order of liquidity and maturity on a Statement of Financial Condition is important because it provides a clear picture of the ease and timeframe in which assets can be converted into cash. This order helps users of the financial statement quickly assess the individual's or family's liquidity position and understand the structure of their wealth. For example, having cash and marketable securities listed first indicates immediate liquidity, while listing real estate and closely-held business interests later shows that these are less liquid and may take more time to convert into cash.

3. CPAs can provide different levels of service for personal financial statements, including audits, reviews, compilations, and preparation engagements. A CPA might choose to perform a compilation instead of an audit or review due to the lower level of assurance and risk involved. Compilations are more common because they require less extensive procedures and evidence gathering, making them more practical and cost-effective for personal financial statements. In compilations, the CPA is not required to verify the information provided by the client, which is suitable for clients who need a basic financial presentation for purposes such as lending or internal planning.

PART 2. AUDITING

Gaining an Understanding of Internal Controls

Today, we're diving into the critical process of understanding internal controls as part of risk assessment procedures. We'll explore the steps your engagement team can take to identify significant transaction classes, assess key risks of material misstatement, and verify the implementation of essential internal controls. During this session, you'll be guided through how to effectively gain an understanding of internal controls, making you not just a smarter auditor but a more efficient one who will be well-equipped to assess the design and verify the implementation of key internal controls, with a focus on making the auditing process both effective and manageable.

Now let's join Chris Martin, CPA, who will lead us as we delve into understanding internal controls and risk assessment.

Mr. Martin

Hi, my name's Chris. Welcome to today's presentation. We're going to be talking about how to gain an understanding of internal controls. So we're going to be delving into the GAAS requirement as part of the risk assessment procedures of how you and your engagement team can really identify those significant transaction classes that your client goes through in order to initiate their transactions and process them all the way through to the general ledger. And then how we go about as an engagement team identifying those risks of material misstatement by assertion within those significant cycles and then identify the internal controls that we would deem to be the key internal controls within each one of those. That's going to help us, again, do the GAAS requirement to understand internal controls, which as we'll see in just a moment, means that we are going to assess the design effectiveness of those internal controls, and then we're going to make sure that we verify the implementation of those key controls. OK. So there's a lot going on in today's presentation, but I hope that the materials and our discussion that we'll have today is going to really make this very, very easy for you to understand and even easier to implement and train your engagement team members. OK. You can see my bio there on the screen. I worked many, many years in public accounting. I started my career with Arthur Anderson. At Arthur Anderson, I had the opportunity to work with many, many different types of companies from small to very, very large ones. And one of the expertises I was able to build within that public accounting experience was an internal controls background. I was instrumental in helping many different firms and many companies actually move through the Sox 404 requirements that happened in the early 2000s when the SEC created the PCAOB, the Public Company Accounting Oversight Board. And then that then required various companies to really focus in on their internal controls. As many of you also already know, SAS 145, which became effective on December the 15th of 2023, also re-emphasized internal controls and gaining that understanding to help us become more effective and more efficient auditors. The way that I like to look at internal controls is it makes us smarter auditors rather than harder working types of auditors. We already work hard enough. Let's just now use all of that expertise and that wisdom to work even smarter. The one thing that's missing off this particular bio slide, we've got it at the end of your materials, is the link to my LinkedIn profile. So I'm going to invite you to connect with me there on LinkedIn. I'll show you that towards the end of the presentation as well. That's a great place that after today, you can ask any questions or seek out any additional information on this particular topic or any other topic that we teach here in Checkpoint Learning. That being said, let's go ahead and jump into today's presentation: How to go about Gaining an Understanding of an Internal Control System.

So you see your learning objectives coming up on the screen now. So upon completion of today's on demand webinar, you should be better able to first of all, explain the GAAS requirement to "understand" the internal controls for a non-public entity. Now I know that this is a non-public entity, but everything that you're going to be learning today would be, would be appropriate for a publicly traded company as well. Just understand that if you happen to be auditing a publicly traded company, there are a few nuances from the PCAOB that have you do a few additional things and have a few additional considerations. And I'll try to work those into our conversation as we go through today's materials as well. So once we understand these GAAS requirements to understand internal controls, we're going to go through the process of trying to understand how we go about identifying the significant transaction cycles. Now we'll be finding that there's a lot of professional judgement that goes into identifying these significant transaction cycles. And that decision making process has actually been primarily affected by SAS 145 as well. And I'll be showing you a few slides that are going to highlight those particular considerations from that newest audit standard that happens to be out. We're also then going to brainstorm for risks of material misstatement and we're going to identify some key controls. Again, going through the thought process in the exercise of that professional judgment to allow you to do that in a more effective and efficient manner. Then we have to then do the second key part of this, which is to verify the implementation of those key controls. Most of you probably already know that there are four ways to go about gathering audit evidence, no matter what hat is. Right? Whether we happen to be auditing inventory or accounts receivable or fixed assets or revenues, or in this particular case we're understanding internal controls. Again, four ways to gather audit evidence. Those four ways are inquiry, observation, inspection, and re-performance, OK. Every audit work program step out there simply consists of some combination of those four ways to gather audit evidence. So as we're understanding these internal controls and I'm discussing the internal control system with my client and they tell me that they have all these various controls in place, that's great. I want to trust my client, but the audit standards require me to verify that. OK. We call this corroboration. So this implementation of key controls means that the client told me that they had a particular control in place. I simply now have to go out there and prove to myself, gather the evidence that I need, that that is true, that that control is in place and that they have they are actually using it. OK? Now we're going to find that verification of implementation of key controls is not going to be sufficient to rely on those internal controls. In order to do that, we have to take the next optional step, which is to test the operating effectiveness of those same key controls. That's going to be outside of the scope of today's materials. And we do have a separate webinar called How to Test the Operating Effectiveness of Internal Controls. It's a one hour presentation and I hope you'll join us here at Checkpoint Learning for that particular presentation as well. Very, very helpful, again, to take today's materials and today's learning objectives to the next step so that you can rely on those controls in order to reduce the amount of work that you might be doing substantively in that particular audit engagement. The last thing there, we see that we're going to identify, we're going to communicate, we're going to respond to any design or verification deficiencies. OK. So we'll be getting into that and how that is going to affect our audit strategy and our audit plan and how we go about designing the various substantive procedures that we might choose to utilize in order to gather the evidence that we need as an engagement team to then opine that the financial statements are ultimately free of material misstatement.

The graphic that you see up on the screen right now is a graphic that I created to help explain the impact of SAS 145, not only on the internal controls, but throughout the audit engagement. So if you haven't had any training on SAS 145, I'm going to encourage you to do that. We've got a number of learning opportunities within Checkpoint Learning for that. And there's a lot of different articles out there from the Journal of Accountancy and various other publishers of that kind of material that explains SAS 145 in very easy to understand terms. And so I'm going to encourage you to check those out. Just do a quick Google search or a ChatGPT search or something like that. Or again, maybe check within the Checkpoint Learning catalog for various learning opportunities related to SAS 145. So, in a real quick summary form, this particular graphic shows you that SAS 145 redefined the definitions of inherent risk. It redefined the definitions of what we would call a significant transaction cycle, a significant account, a significant disclosure, a relevant assertion. It really kind of goes throughout the entire thought process of what an audit and what a risk assessment and risk identification is all about. So what you see here on the screen is, on the left hand side we're talking about the magnitude of a potential misstatement, and at the bottom we're talking about the likelihood of a potential misstatement. So SAS 145 says, hey, in order to identify a risk of material misstatement, there has to be a risk that there's going to be an error or fraud. And in order for that to be a risk of material misstatement, that potential magnitude of that error or fraud that you've identified has to be greater than that level of performance materiality that you determined earlier on in your engagement during the planning process. So it has to be something that would result in a material error or a material fraud. We also have to look at the likelihood of that same risk coming through to manifestation, right. So it has to be greater than a remote possibility. So it's something that is at least reasonably possible and something that would cross that imaginary line of materiality. OK. And the SAS 145 says it's an “and”: it's magnitude and likelihood. OK? So it's not “or” it has to be both of those. Now as you see as we get further and further away from the corner point, right as something becomes more and more likely or more and more material, we start to approach this area called significant risk. And a significant risk means that we have something that's very,

very material and or very, very likely for that to happen. And significant risks carry certain audit consequences with them that require us to do some additional work. One of the ones that's going to apply to today's topic is if I have a significant risk, I know that I'm going to have to have that as a significant class of transactions. We're going to need to understand the internal controls related to that particular type of transactions that gets processed through the client's system. OK. And we don't even have to approach that significant risk line. We're going to learn here in just a few minutes that if I have identified a risk of material misstatement within an assertion, OK, within a particular financial statement line item, that also is going to create a significant transaction cycle that then we have to understand these internal controls over. OK. So for example, if we were to identify a risk of material misstatement that let's say plant, property, and equipment. could easily, OK, and likely have a material error or material fraud associated with it, then that particular assertion, let's say it's the existence assertion, would then become a relevant assertion. And that relevant assertion means that we're going to have to do additional work including understanding those internal controls. I hope that becomes a little bit more clear as we start to navigate through the remainder of today's presentation. OK.

All right. So let's kind of review really quickly what the audit team might have done up to this particular point in time. The graphic that you see on the screen right now, I often times refer to it as the hourglass, and I'm a big fan of this particular graphic because it summarizes all of the different GAAS requirements from top to bottom. Now you and your engagement tag-team might add to this particular graphic. You might do things outside of this and that's perfectly OK because hopefully your professional judgement is leading you to that particular decision. But these are the GAAS requirements if you want to look at them that way. So let's just start really quickly at the top. We're going to go through some kind of client acceptance and continuous decision making process at our firm. Right. Now, GAAS is going to get involved. There's certain things that we have to do from a generally accepted auditing standard standpoint, right? We have a webinar, for example, called Initial Audit Engagements. And that particular Initial Audit Engagements presentation walks you through some of those decision making processes and those thought processes that your firm might go through before they decide to take on a new client or to continue with an existing client. But once we've decided that we want this client, we're going to take on this particular engagement, we ultimately then determine this preliminary level of materiality. Now obviously, we're doing this fairly early in the engagement. So I want you to know that materiality is very fluid, right? This is just our first guess, if you will, and what we think this level of materiality is going to be. And then we might adjust that materiality level up or down based on what we learn as we make our way through the rest of this particular hourglass. Now, the reason that we identify materiality early on is because we have to have some kind of an idea about what ultimately would be material. Because we're about to enter into these risk assessment procedures that you see here on the right hand side of your screen where we're going to be performing these various items in order to identify potential risks. So to identify a potential risk, I have to have that level of materiality in mind. OK. And again, remembering that it's fluid, it may change up or down based on what we've learned. All right. So we start to then enter into what we call the risk assessment procedures phase. This is where we are, what GAAS requires us to do. Then in this dark orange 1/3 says: we have to understand the entity, we have to perform certain fraud related inquiries, we have to perform a preliminary analytical review, and, the subject of today's presentation, we have to understand internal controls over the significant transaction cycles. We see there in the blue arrow, that means that we're going to be assessing the design effectiveness and then verifying the implementation of the key controls within those cycles. Now to put all of this kind of in the big picture perspective, what do we do with this information? So we're performing all of these different risk assessment procedures to identify those potential risks. How does this impact with internal controls? Well, I want you to think of the internal control system kind of like a filtration system. So as the client initiates a particular transaction and it starts to be processed through their transaction processing procedures, right, errors and frauds can be introduced. So hopefully the client has put certain internal controls in place, i.e., their filtration system, that would prevent or at least detect and correct those material errors as they try to get through all the way to the general ledger on the other side of this filter. So if my client has a really good filtration system, again, they're going to prevent those material errors and frauds, or they're at least going to detect them and correct them on a timely basis. So that's the entire idea behind understanding internal controls. Hey, how good is their filter? Is it pretty solid or does it have holes in it? Because if they have holes in it, right, that means that an error or fraud can get through and make its way to the general ledger. Well, those are the things as an internal or as an auditor, we're really worried about. Those are the risks that we're going to have to deal with in our audit programs. OK. So understanding internal controls, hey, how good does their filter appear to be? Now again, ultimately if we decide that we want to rely on this filtration system, we're going to do some additional work to actually test it to see if it has been operating throughout the entire period. But if we happen to be auditing a non-public entity, this is completely optional for us. We do not have to test those controls. If you happen to be auditing a publicly traded company, you do have to test the operating effectiveness of those internal controls. So there's a big difference there between non-public and publicly traded company audits, OK, that you have to test the operating effectiveness of those particular organizations. Why? Well, because the PCAOB and the SEC require you to render an audit opinion about the effectiveness of that internal control system. The AICPA does not require that for non-public company audits. So how do we use this information from these risk assessment procedures? Again, we identify those potential risks. Now, you see, as we enter into that blue center section, we're going to bring all that information into an engagement team setting where we're going to have various team meetings where we discuss what we found. We discussed those ideas, we bring them up to the engagement team. We decide together. We debate them. We discuss them, right. We negotiate them. We determine which risks do we as an engagement team believe are ones that we need to deal with. And then we use our professional judgment to determine if those are big risks or medium risks or little risks or no risks. Then we use that information to go down to the bottom area, right, that light peach colored, where we're then going to design audit work programs to go out and test to see if those risks actually manifested themselves in the client's books and records. And then we perform those particular procedures to allow us to ultimately opine on whether those financial statements are fairly stated. So today's presentation is all about that understanding internal controls, so assessing the design effectiveness, verifying the implementation of the key controls, again, in order to identify those potential risks that we can bring to the attention of our engagement team. So don't make this harder than it has to be. This is an area where you will get outside of the accounting department. You're going to be forced to go talk to people in the operations department, maybe in the marketing department, in the executive department, in the sales department, so outside of the typical accounting realm. And so you start to develop business relationships throughout the organization. So personally and professionally, I really enjoy working with internal controls. I think it helps me really learn the company's business, right. And again, it helps make me a better auditor because I'm always thinking about, hey, what could go wrong here? Where could that material error happen? How likely is it going to be that that would happen? And does the client do anything to stop it? And if not, I have to be the one to stop it, right, in order to render that clean opinion about the financial statements.

So, I hope that you were kind of charged up and enthusiastic about working in internal controls, especially if maybe you've never done so before. Maybe you have worked with internal controls and you don't like it. Well, maybe this is going to shed some light, it's going to give you some good ideas and different ways to think about it that's going to make you, again, more effective, more efficient and maybe more enthusiastic about getting involved with those internal controls. So as I mentioned just a little bit earlier that "understanding" internal controls and notice the quotation marks there, it simply means that we have to do two things. We're going to evaluate the design effectiveness of this internal control system over the significant transaction cycles. What does that mean? Well, that means, as you see here on the screen, that we're going to be considering whether a control either by itself or in combination with other controls, are they or is it capable of effectively preventing and or detecting and correcting a timely or a material misstatement on a timely basis. So Chris, what do you mean by a timely basis? Well, it means before you as the auditor find it. OK. So if you go out and you're doing your audit procedures and you find a material error or material fraud, that means the client's internal control system failed. A material error or material fraud got through whatever it is that they do and the auditor found it. OK. Remember, you are not a part of the client's internal control system, even though I think the clients would like for us to be that. They would like to give us that responsibility to find all of those different material errors and frauds. But remember, the evaluation and the implementation of the internal control system is management responsibility. That shows up in the engagement letter, that also shows up in the management representation letter. And that responsibility even shows up in the audit report. Right. Management is responsible for the implementation of an internal control system. Right. So we can't be a part of that. So once we've evaluated the design, remember we have to take that corroborative step to say I'm going to do more than just inquiry. The client told me that they have this control in place or that these controls are in place. I'm going to go out there and inspect and observe, maybe even re-perform, to ensure that those internal controls truly are there, that they really do exist. So we see here that we're corroborating that the control does exist and that the client is using it. OK. Remember, the next step, if we so chose, would be to test the operating effectiveness of those same controls.

OK. So as we start to talk about internal controls, we can't avoid talking about what we refer to as the COSO framework, C-O-S-O, Committee of Sponsoring Organizations of the Treadway Commission. Now, the COSO organization actually had a publication many, many years ago. It was called Internal Control Integrated Framework. It's probably there in your firm's library somewhere, right, if you want to take a look at it. But this publication was written to management of different companies that told them, hey, if you want to create an internal control system that's effective and efficient, there are five interrelated components that you need to consider and you need to build into your system. Well, those five interrelated components are shown on the face of this cube that you see there. We have to have a solid control environment. We have to have management's risk assessment procedures in place. We have to put in control activities, the things that we actually do that prevent and detect and correct. We have to train those people that are going to be performing those particular controls how to do them. And we have to have some internal communication about whether or not those controls are actually working or not. Then we have to have one more layer of controls in place that would then monitor the effectiveness of those. How does management make sure that the internal controls that they put in place are actually working? OK. Now, as an auditor, we kind of go through this same thought process. But remember, this is on the side of the table that management sits on. What is management doing for themselves to create this internal control system. Some clients are going to be really good at it. Some clients are going to be really terrible at it. Other clients are just going to need some help. OK. So we, if you'll remember back to our learning objectives, we're going to be communicating any internal control deficiencies that we come across to those charged with governance and to management so that they can put a remediation plan in place, so that hopefully over, you know, several years, their internal controls are going to get stronger and stronger and stronger, OK, which is going to give us a lot more items that we can potentially rely on as we develop that business working relationship with those same clients. Now you'll notice that the top side of that particular cube that's on your screen, internal controls really do operate in the operations phase of the company. They operate over financial reporting and they operate over compliance. The controls that we as financial statement auditors are primarily interested in would be those that fall into the middle category, those controls over the financial reporting. So things where the assertions within the various financial statement accounts can be overstated or understated or improperly stated, whatever you want to call it, right, that there's an error or fraud associated with those particular assertions. Now, obviously we have to also be concerned somewhat with compliance and with operations because compliance means, what kind of controls do they have in place that would make sure that they're in compliance with various laws and various regulations that their company is required to be operating within. So obviously, if they're out of compliance with laws or certain regulations, that ultimately is going to impact financial reporting, right? Because maybe there need to be certain accruals or maybe there's going to be going concern considerations, etcetera. Same thing with operations. Obviously the company has certain operational activities they get involved with. And so we would need to make sure that their operations aren't failing, right, or creating a financial reporting issue that we would ultimately need to deal with through those types of controls as well. Real quick example of that one, often times when I'm teaching internal controls, and we'll be brainstorming here in just a moment together, that let's say that we have a salesperson who gets a sales bonus and they get a sales commission and maybe they're held to a sales quota every month they have to sell a certain amount, right? And so one of the things that we might be concerned with is how might a salesperson understate revenue? What could they do? And often times when I'm teaching students live or sometimes even in a live presentation, and we're doing this brainstorming live, they'll go, oh, well, what if the salesperson made a sale and they filled out a sales order form, but they've already met their sales quota for the month. So they just decide I'm going to hold on to those sales orders and I'll turn them in tomorrow or next week or next month, whatever it is, the next accounting period. Right? So, oh, they've understated revenue. And it's like, OK, let's think that through. If they don't turn in their sales order forms, those sales orders don't get processed through the order entry process. They don't go through the warehouse picking process. They don't get shipped. So the revenue recognition criteria never do get met. And so therefore, the general ledger is perfectly OK, right? There's no misstatement there. If you were to find $25,000 worth of sales or potential sales that a salesperson never turned in, you wouldn't put an audit adjustment to debit accounts receivable and credit revenue. Why? Well, because the GAAP revenue recognition criteria were never met within that particular process. OK. GAAP tells us that inventory has to be shipped or delivered depending on the FOB destination or FOB shipping contract that happens to be there. And if they're delivering a service, that service has to have been rendered, right? So if we never reached that, that point, there is no revenue recognition. So in that particular case, I would say, hey, that's not a financial reporting issue, it's more of an operational issue. OK. I would don't want to tell my client, hey, because you don't have the right controls in place to maybe account for all of the different sales orders that are out there to make sure that they all got turned in, you've got an operational problem, you're potentially missing out on sales that could have been recorded this, but they're not. OK. But your financial statements are perfectly OK because of that. So we do need to draw a distinction between the operational types of controls, the financial reporting, and the compliance related types of controls as well.

Now when we start thinking about the various kind of clients that we have, and this is a pretty good graphic that kind of shows you from a professional judgement kind of a standpoint where these controls might have various degrees of importance, right. So we see here within a smaller organization, often times those monitoring controls play a really big role within the organization. OK. Whereas we see for example, the green ones, the activity-level controls, play a little bit of a smaller role in the control environment plays a bigger role than in the larger organization. Because if you compare and contrast that to the one on the left hand side, we see in a larger organization really, really reliant on those control activities that happen to be out there. So let's talk this through just really quickly. If I have a smaller organization that I'm auditing, OK, let's say that I'm the owner of a company and we've got 50 employees that happen to be out there. Well, if we have 50 employees, I might know as the owner of this company, or let's say I'm a departmental manager, for example, and I've got 50 employees beneath me, I'm probably going to know what my biweekly payroll should be. Right? I know how many people I employ. I know what their wages are. I know what their salaries are. I know how many hours got worked. Right? So if I were to, for example, at the end of the payroll period, find out what my departments or my company's biweekly payroll was and I just did an overall analytic on it, OK, maybe I compare that to the last payroll, or to the same payroll for the previous month, or I did a real quick and dirty calculation and said, hey, I think my payroll should be about this much. I'm probably going to be very accurate in my expectation. So analytically I could probably determine whether there's a material error or material fraud within my payroll expense. So that biweekly review would be considered a monitoring level control. Right. Now, the reason that the monitoring controls take such a big role in a smaller organization is because they can. Right? Because those departmental managers or those owners probably are very privy to all of the different pieces of information that would affect that particular balance. Whereas in a larger organization, if I had, you know, 5000 employees under my charge, I wouldn't necessarily know if there was a material error or a material fraud in my payroll expense because it's hidden inside that giant number. OK. So again, those particular control activities are going to play a bigger role. So for example, somebody taking the pay-cards, right, and maybe recomputing the number of hours that were worked. Somebody else is making sure that the appropriate salary level or wage levels were applied to those various items. Somebody's recomputing the payroll for those particular employees, etcetera, right. So we have much more opportunity in a larger organization to make that happen. Larger organizations typically also have more personnel, so they are able to achieve that segregation of duties that would also be necessary in order for a control to be appropriately designed. In a smaller organization, it's a little bit harder. Maybe there's only one person in accounting, or a few people in accounting. So you wouldn't have really good designed control activities simply because the same person who's maybe creating the number is also the same member who's reviewing that calculation or that number. OK. So again, it's just kind of a little thought process and I think it's a really good way to look at larger versus smaller companies and the role and the impact of the various COSO components at those various organizations.

Now, to exercise then the GAAS required understanding of internal controls, we typically follow what's often times referred to as a top down risk-based approach. Risk-based meaning that we're going to base all of these internal controls only on the risky areas. Right. If something's not risky, OK, I probably don't care if they have good controls or not, right? The risk of there being a material error or material fraud is low, or hey, the risk is high from a likelihood standpoint, but the potential magnitude … I can't think of a way it would ever become material … I don't need to worry about those. OK. So we want it to be risk-based first of all. And then we're going to take what's called the top down approach, which means that we're going to apply the highest level of controls first. And we're going to work our way down the internal control hierarchy until we are satisfied as the auditors that the client has enough controls. OK. And I'll be explaining this as we go through this entire process, but think top down, risk-based. Top down also meaning I don't need all of the clients controls. If I'm satisfied that there's two controls that work, but there's 20 total controls in that same area, I'm OK with just having two, right? Those would mitigate my risk, mitigate meaning prevent it or detected and corrected on a timely basis. And all of those other controls then are just kind of icing on the cake, right? I'm glad that they're there, but even if they weren't, we're probably still OK. I'll have lots of examples coming up for you here in just a few minutes. Now, the first step then in this top down risk-based approach is we want to identify these entity-level controls. Now, these are the highest level controls that are out there.

So we ask ourselves, well, Chris, first of all, what do you mean about an entity-level control?

So an entity-level control, first of all, is defined as an internal control that has a very pervasive impact. OK.

So pervasive impact meaning that it's not affecting directly any particular financial statement line item.

So it's not an internal control over payroll or an internal control over revenue or plant, property, and equipment or accounts receivable or expenses.

It's an entity-level control that's pervasive to the entire general ledger. We're going to have some examples of those here in just a moment. Whereas we'll be talking about in just a moment what we call an activity-level control. And those particular activity-level controls are specific to various financial statement line items and ultimately to the financial statement assertions that comprise those financial statement line items. So why would we care about these entity-level controls? Well, first of all, as you see on the screen, these serve as the foundation for the activity-level controls. So the activity-level controls can't work if the entity-level controls are not properly designed and implemented or they don't operate effectively. OK. A real quick example of this. OK. I don't want to get too far ahead, but in a few minutes we're going to be talking about an IT application control. An IT application control simply is an activity-level control that's performed by the computer system rather than a person. OK. So let's say that we're really concerned that these salespeople that get a commission and a bonus, OK, and they're held to a quota, we're really worried that they might overstate the sales, the revenue, because they're going to create, let's say, a fictitious customer. Right? They're going to fill out a sales order form for pick this customer. They're going to turn that into the order entry clerk. Well, the order entry clerk then is required to agree this customer name or number to let's say an approved customer database. That's a really great control. Hey, order entry clerk, you are required to, for every sales order, compare that customer name and number to the approved customer database. Why? Well, because you're the one that's going to prevent or detect and correct a fictitious customer from ever getting through to the system. OK. So that was the information and communication piece of COSO, by the way. I communicated to this, this control performer the importance of why he or she is performing that particular control, what it is intended to do. OK. That's part of that information communication component of COSO. So let's say that this order comes in, the salesperson compares it to the approved customer database. Great. OK. Or the client has automated that and as the order entry person is entering that customer name or number, the computer system takes over and the computer system automatically compares that customer name or number to that approved customer database. Great. That's now called an application control. OK. Human versus non-human performing it. OK. Activity-level versus application control. No big mystery there. But in order for that application control or that activity-level control to be effective, I'm going to stand back as an auditor and say, well, wait up, before I can rely on that, right, how do we know that that approved customer database is protected? Could that salesperson who created the fictitious customer just log into that database and enter that fictitious customer name or number? Well, if that's the case, then this control is worthless. Right? So that password, that protection, that security over that database, is an entity-level control that would allow this activity-level control or this application control to actually work. OK. Another type of an entity-level control might be the control environment. Management's attitude, management's integrity, management's desire to get things right, management's appreciation of the audit process, management's attention to hiring competent personnel, all those kind of things, right. So if I were to question, let's say management's integrity, gosh, I don't care how good their internal controls might appear, right? You're kind of falling apart at the entity level. I'm not going to trust anything that's going to be happening within this internal control system because I don't trust management, right? That internal control system failed at step one, the entity-level controls. Now you might be going, hey, you know what, if I don't trust management, I'm probably going to go back to the very beginning of that hourglass that you showed me a little bit earlier, Chris. I probably don't want to accept or continue with this particular client. And I'm with you, right? Absolutely. You probably need to revisit those, those decisions that your firm probably made. And if you decide to keep that client, you're probably going to reconsider that preliminary level of materiality where you're going to say, hey, if we're going to audit this company and we question management integrity, we're probably going to audit the heck out of it by having a really, really, really low level of materiality so that we do a lot of extra work. OK. So for now, just understand these entity-level controls are the foundation for the activity-level controls. Again, it's kind of step one and it assists in the scoping of the other controls. How many other controls might we need, OK, depending on what we find there.

So, of the components of COSO that we saw in the cube a little bit earlier, these are the ones that are considered the entity-level controls. OK. So, the control environment, I just defined it for you just a moment ago, but you see here on the screen, these are the attitudes, the awareness, the actions, of those that are charged with governance. And I'm going to throw management into that mix as well. It includes all the things like anti-fraud controls as well. Management's risk assessment. How does management consider risks and what do they do to take actions to address them? So, of the things that we're going to be doing here today to understand internal controls, this really is kind of management's risk assessment process as well. How did they identify their significant transaction cycles? How did they then understand the process that their company follows to process those transactions through that cycle? Have they brainstormed what could go wrong within those particular cycles so that if something could go wrong, i.e., and error or fraud, they can put a control in place. Right? Which are those control activities that you see are missing from this table, because the control activities are the activity-level controls, the answers to this risk assessment process, the information, the capture of events and conditions that affect the financial reporting. Notice in yellow there, this includes the information technology general computer controls. We're going to have a little quick discussion on that coming up here in just a moment, but just know that ITGCs, these general computer controls, exist within the information and communication component of COSO. The communication, I described it just a moment ago when I talked about training that sales order entry person, right, on the importance of what they're doing, OK, and how they need to be very diligent and making sure that no fictitious customers get entered into the system. This is where we're communicating those financial reporting roles and the responsibilities. And then lastly, those monitoring controls. These are those major activities to monitor in current control. I described a little bit earlier a monitoring control where the owner or maybe a departmental manager is reviewing that biweekly payroll to see if it makes sense. Right. They're doing an analytical procedure to compare their expectation to the actual number to detect whether or not there is a fishy looking number, right? There's an anomaly that happens to be there which might indicate an error or fraud. OK. So monitoring controls become very, very important. They are a big component of the top down risk-based approach because we're going to stop start with these monitoring controls and we're going to see if the client is monitoring these items. Is that enough? Do we need to dig into these control activities that operate at a more transactional level? OK. So stay tuned for that discussion coming up here in just a few minutes.

Now ITGCs versus application controls, I kind of give you a little bit of a hint on these a little bit earlier. Just one thing to keep in mind, this discussion was modified by SAS 145, remember effective on December the 15th of 2023. And it basically says we have a renewed focus on internal controls related to the IT system. OK. So you might need to get some additional training. I've got a couple of slides here that give you a little bit of hints, right, on some of the things that you needed to be considering. But basically SAS 145 says no longer can you put blinders on and ignore this computer system because it is a source of really potential material errors and frauds. We really need to look at the internal controls as they relate to this computer system. So we see here on the left hand side, these ITGCs are those companywide policies and procedures that ensure the proper function and the control of the IT system. It ensures that the IT system does what they need it to do, does it when they need it to do it, and it protects things from unauthorized access, changes in use. And again, these are often times classified as the entity-level controls because they have a very pervasive impact. So let's say that you're interviewing me, and I happen to be the controller at your client. And you notice that I use QuickBooks. OK. And so you just ask, hey, Chris, who has the password to QuickBooks? And I'm like, oh, password? Oh, yeah, yeah, it's on my computer. I lock up my desk at the end of the day, you know, there's not really a password to QuickBooks. And so a red flag goes off to you as an auditor where you're like, wow, whoever can get into Chris's office has complete access to QuickBooks. There's no password. Right? And then I go, gosh, from an auditor’s perspective, where's an error or fraud going to happen? It could be anywhere in that general ledger, right? OK. So that would be an entity-level control to have that password that protects my books and records from an error or fraud that could be pervasive. OK. If you've taken any other auditing classes with us here at Checkpoint Learning, you'll often times hear us refer to things as being kind of an overall risk or a financial statement level risk. That's what we mean here. It's an overall risk; it’s protected against by an entity-level control. An entity-level control deficiency creates an overall risk. OK. So they kind of go hand in hand. Same thing with activity-level controls. An activity-level control is an analogous to an assertion level risk. So if I'm missing an activity-level control, I'm going to have an assertion-level risk. OK. So that means that I have more of a risk there that I can then audit through with my audit procedures. Now we see here on the right hand side of our screen, these IT application controls are activity-level controls that are simply done by the computer system. These are controls that prevent and or detect misstatements in a particular process on a timely basis. And I already gave you one example of an IT application control and they could be, there could be many, many, many at your clients, whatever your client has automated within their system.

So Chris, do I have to be an IT expert in order to meet the challenges of SAS 145 and this requirement to understand the IT general computer controls? And the answer is no, you don't have to be an expert, but you do need to sharpen your skills. OK. If your client has a fairly complicated or maybe very comprehensive system, this may be an area where if your firm does have an IT audit division, right, you might want to bring them in to help maybe do some assessments of that IT general computer controls. If you don't have something, a resource that like that is available to you, you might engage with an IT specialist that can help you to talk to the clients, right? And their IT people, if they have those in place and we can get some good information from them as well. Just remember, inquiry alone not sufficient. So we have to corroborate it, what it is that we learn from them. Now, from the standards, it tells us that, hey, you know what, this is almost a little bit of a checklist of the things that you need to be looking into as you're considering this internal control system at the ITGC level. So, these are the items that pose specific risks to internal controls. Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both. Right? So hey, client, what have you ever done to make sure that your computer system is computing things properly and it's processing those transactions appropriately through your system? OK. What about unauthorized access that could result in a destruction of data or improper changes to data? So we're talking about things like passwords. Maybe we're talking about things being behind a locked door so that people can't physically get to them. The possibility that IT personnel could gain access privileges beyond those that are necessary to perform their assigned duties. OK. So we're talking about a segregation of duties problem here. Right? Those IT people have access to too many things and there's no oversight on to determine whether they are doing something that would be erroneous or maybe fraudulent in nature. Unauthorized changes to the data that's in those master files. We mentioned that one just a moment ago where I said could the salesperson log into that database. Unauthorized changes to the systems or the programs. Failure to make the necessary changes to the systems or programs; for example, what version of the software are they using? OK. Have they updated their QuickBooks, right, to the most current version? Right. Were they still operating on one from 10 years ago? A inappropriate manual intervention or potential loss of data or inability to access the data as required. So, who can get to the information. Now, if you're not very good at ITGCs just yet, OK, just know that there's going to be a lot of additional training coming out. There are some training opportunities for the Checkpoint Learning. There's lots of different resources that are out there that will help you through this. I know for example, the PPC and CCH through their knowledge based audit. I believe that even the McGladrey forms, they have certain forms and checklists and questionnaires that will help you navigate your way through the IT general computer control environment. So make sure that you use those particular practice aids as well. OK, I wished I could go into a lot of detail here today with you about ITGCs, but again, that could be its own webinar presentation. So make sure that you check out those other learning opportunities to, again, strengthen your skills in that area.

So some best practices when we're talking about these entity-level controls, just remember first of all, that they are the foundation of the internal control system. You notice the picture that's on the screen, is the green light. OK. When you're understanding the internal controls at the entity level, do you have a green light to continue or does that light turn red and say stop? OK. We can't even get past step #1. OK. So remember again, they're the foundation of the internal control system. Those activity-level controls are dependent upon them. We want to focus only on the key controls. OK. Because your client might have many, many, many controls that are out there within the control environment or the risk assessment process, etcetera. But remember, you only need enough controls to satisfy you that they've met the objective of that control itself. OK. Make sure that you make your documentation very client specific. What this is referring to is if you go out there and use, for example, a PPC form, like PPC will have a form on different types of controls that might exist within the control environment. Right. You don't want to just use the generic wording that PPC provides. Remember, they make those forms available to lots of different audit firms so that you can use them on lots of different types of engagements. So they're very generically written. They're good forms, but you need to make them very client specific in order to meet the documentation requirements of AU-C230, which tells us that our work has to be re-performable by an experienced auditor-reviewer who comes in cold to this particular engagement. Can they re-perform your work? Make these items very client specific. Include the information technology general computer controls. Remember, inquiry alone is not evidence. So we do have to corroborate what we learned. And make sure that we consider the impacts of any controlled deficiencies here, remembering that a control deficiency, remember, there’s a hole in that filtration system where an error or fraud can get through. OK. All right.

Practical application question here for you. As we now transition into our discussions of the activity-level controls, remember that we will only be performing our design and verification of implementation work on those transaction cycles, those account balances, and those disclosures that are deemed to be significant. Now your engagement team is going to have to go through a thought process where you all are going to determine which ones are significant, which ones are not. You're going to apply SAS 145 to help you exercise that professional judgment. Remember, a significant transaction cycle, a significant account balance, or a significant disclosure is one that contains one or more risks of material misstatement. A risk of material misstatement, if you harken back to that very early slide, is one that has a potential magnitude greater than materiality and a likelihood greater than remote possibility. OK. So to help us out here, GAAS tells us, hey, regardless of your professional judgment, there are two transaction cycles that are automatically already on your list. OK. Which ones are they? OK. I know that there are three listed there. So which one is not and which two are always significant? OK. Well, let's just go ahead and answer this particular question. The first one here is going to be revenue recognition. Hey, Chris, why is revenue recognition already on my list? Well, you may recall that GAAS tells us that there is always going to be a risk of improper revenue recognition due to fraud. So we already have this significant risk built into GAAS. Well, that significant risk then says, hey, you've got to understand the internal controls over revenue. OK. We also learn in GAAS that there's always going to be the risk of management override of internal controls. That's always a significant risk on every engagement. That simply means that management is unhappy with their general ledger at the end of their accounting, so they decide to change the numbers, OK, by making them higher or lower or whatever their motivation happens to be in that particular circumstance. So we're required then to actually perform some tests over various journal entries, particularly those that are used to create the financial statements. OK. So we have this financial closing reporting which is going to be the significant transaction cycle over that year end or accounting close and adjusting and creating the financial statements types of adjustments that are there. So because we have this management override of controls risk and this risk of improper revenue recognition due to fraud, we have these two cycles to already deal with. So cash disbursements is a good guess, if any of you were to actually answer that particular one as being one that's always significant. But GAAS says I'm going to leave this up to your professional judgement. OK. Cash disbursements, cash receipts, payroll, purchasing cycle, etcetera, these are all left up to your judgement as an engagement team. So cash disbursements is not one of the ones that is always significant. I think it's very likely to be significant, but it's not automatically always significant.

So after we've got this green light then to continue after these entity-level controls work, we're now going to move into step two of the top down risk-based approach. This is where we then as an engagement team identify the significant transaction cycles, we identify the significant account balances, and we identify those significant disclosures. Remember SAS 145 tells us that what makes any of these significant is the existence of a risk of material misstatement within them. OK. So a lot of things are likely to make the cut. Once they make the cut, we put them on our list, we know that we have to understand the internal controls, meaning that we're going to do all the things that we're talking about here in today's presentation from this moment forward. OK. Now, once we've identified those significant transaction cycles, those significant account balances, or disclosures, notice that the next step here is to understand the flow of those transactions. Hey client, I need to get a process narrative of how you initiate a transaction and how you process it all the way through to till it gets to the general ledger. Then that financial closing reporting cycle picks up that general ledger and follows all of that processing into the financial statements are actually produced and then distributed to the users. So it really is kind of a cradle to grave understanding of these various items. So I have to get a process narrative. Now, my client may engage me to write that process narrative for them. That's a nonattest service that we're welcome to perform as part of our test engagement, our audit here. Right. But the client may be able to write those process narratives up for us, so you can put that on your PBC request list. But regardless of whether the client does it or whether you draft it up, you want to make sure that it is accurate because we're going to do a lot of work based on our understanding of this process itself. So we want to make sure that we understand it very well and that we have an accurate representation of it. My recommendation here and what I would do as an auditor here, I'm probably going to do a process walkthrough where I'm going to take this narrative, I'm going to go out to the initial person who initiates one of these transactions, maybe for example, for the revenue cycle is that salesperson. And I'm going to go talk to the salesperson, be like, hey, tell me what your dot job is all about. How do you go about initiating a sale? And I'm going to learn from them. And I'm going to be comparing what I learned from what I'm seeing here in the process narrative. OK. What happens next? Oh, I turn in all these different sales orders to the order entry clerk. OK, thank you. Very nice to meet you. I'm now going to go talk to the sales order entry person, find out what he or she does, make sure that my process narrative is accurate and complete. Then what's the next step? What's the next step? What's the next step? What's the next step? Follow it all the way through. OK. Now what we're ultimately going to do then once we understand this flow is we're going to identify the control objectives. Now, if you've ever taken an audit class for me, I call these the "what could go wrongs." OK. Because I'm asking myself throughout this process, what could go wrong here? OK. Meaning how could this salesperson create an error or fraud? How could the order entry person create an error or fraud? How could this warehouse person create an error of fraud? How could the shipping department create an error of fraud within revenues and accounts receivable? OK. Now, I'm going to be doing that based on the financial statement assertions. So how would they overstate? How could they understate? How could they put it in the wrong period? Right. How could they create a mathematical error? How could they misclassify these in the general ledger, getting into the wrong account? So, I go through all the different financial statement assertions to help me brainstorm these risks, these control objectives. OK. The "what could go wrongs" that are out there.

So, three questions. How does the client process these transactions? OK. So we're going to review or create these process narratives for each significant transaction cycle. We're going to make inquiries of the appropriate client personnel. And as I mentioned, I probably want to do a process walkthrough here to corroborate those inquiries to make sure I have a good narrative. Then we're going to brainstorm. What are the risks? What are the control objectives related to each relevant assertion within that process? And I'm going to use those assertions then to brainstorm for various frauds and errors throughout that process. Then ultimately I'm going to say, OK, now that I have these risks, what is that my client do that would prevent or detect and correct those errors? So I'm going to go out and look to see if they had entity-level controls and or activity-level controls that would mitigate those particular risks.

So let's do this as a real quick case study together. OK. So let's say that we have this client. OK. It's a first year audit client for our firm. The primary purpose of the audit is to support a creditor's lending decision. This company happens to be a C corporation, and they're very focused on earnings. OK. They want to make a lot of money, earnings per share, maybe it's a critical key performance indicator for them, for example. Right. The sales personnel, as we're learning in the top part of that hourglass a little bit earlier, is that the sales personnel are compensated via commissions and bonuses based on sales and they're held to monthly sales quotas. OK.

So we want to use that information then to brainstorm for risks by relevant assertion. OK. Now notice that we do this in this engagement team meeting setting. OK. So hey, what do you guys think? Let's go through all the different assertions and see if there could be a potential error or fraud in there. OK.

So you're going to brainstorm each one of those. Now remember the SAS 145 definition of relevant assertion is what you see here on the screen. This is an assertion about a class of transactions, an account balance, or disclosure that is relevant when it has an identified risk of material misstatement. A risk of material statement, as we discussed already today, exists when there is a reasonable possibility of a misstatement occurring, OK, remember that's the likelihood, and, OK, notice that "and" is in bold red, if it were to occur, there is a reasonable possibility of the misstatement being material. OK. It's going to cross that line of materiality. So the determination of whether an assertion is relevant, OK, is made before the consideration of any related internal controls. That is, the determination is based on inherent risk. OK. So if you're familiar with the audit risk model, remember AR, right, equals inherent risk times control risk times detection risk. OK. We cover the audit risk model in a number of our audit training. So I'm going to assume that most of you already know, OK, what the audit risk model is all about. So this IR times CR is what risk of material misstatement is all about. Now, the way that SAS 145 then altered this definition is they're saying a relevant assertion is one that we look at before we even consider any internal controls. So really a relevant assertion is based on the inherent risk assessment that we would find through our professional judgement as we discuss these with our audit engagement teams. OK. So if there's an inherent risk within an assertion, we're going to have a risk of material misstatement within it and that's going to make that particular assertion relevant. We use those relevant assertions then to drive the brainstorming process.

So let's say that we use that information from that client that we saw in that previous slide. And this particular engagement team went through that process narrative and they determined that these are the ones that are the relevant assertions. They're really concerned about the overstatement of revenues and accounts receivable. OK. They're concerned about the rights assertion. They're concerned about the valuation assertion of accounts receivable. Right. And they're worried about the cut off, that the sales personnel could easily influence the revenue transaction to be recorded in the wrong period.

So your job here then is to really think through, OK, and brainstorm some potential risks that are associated with this. OK. So remember, these salespersons can go out and negotiate sales with customers. They can negotiate the product, the price, the quantity, the shipping terms, the date needed, etcetera. They fill out these order entry forms which are then forwarded to the order entry clerk each day. So we're only starting with a starting point, the initiation of this transaction. So what I want you to do is just simply brainstorm, OK, using these relevant assertions that are here, what could the salesperson do that could create an error or fraud within each one of these assertions? So that's kind of what we do in this audit planning meeting. Now, if I were to stop today's presentation, OK, and you're welcome to pause this and kind of think these through on your own, but this is what we would do in an engagement planning meeting where we're brainstorming. So I've got some potential brainstorming answers here for you. OK. And they're towards the end of your materials.

And these are some possible potential risks. OK. So let's think through that; this is what the engagement team came up with. They said, hey, you know what? To overstate accounts receivable and revenues, OK, and to create a rights assertion problem, the salesperson could easily overstate the price. They could overstate the quantity. They could maybe enter the wrong product or the wrong model number, or maybe the wrong customer, or create a fictitious customer, or create a fictitious order. They could have multiple order entry forms for that same order when it comes to the cut off, meaning they could record it in the wrong. They could treat an FOB destination contract as an FOB shipping point. That's going to record it too early. Right. They could ship earlier than they agreed to with their customer in order to get it into the wrong period. When it comes to the valuation assertion of accounts receivable, they could sell above the customer's credit limit. Hey, they're already above their credit limit, I shouldn't sell to them. Right. This is riskier, but I'm going to sell to them anyway. Or maybe they sell to a poor credit risk customer. Maybe they're already past due on their current accounts receivable. OK. So we come up with these brainstormed risks that are here. Now the engagement team is going to apply some professional judgement. They're going to put it into that SAS 145 matrix that I showed you a little bit earlier, and we're going to say, hey, would these result in a potentially material error or fraud? And are these at least reasonably possible? If they don't meet those two criteria, then we can scratch them out. We must say, hey, you know what? This would never happen. Let's just take that one off the list. I can't see where that could ever be a risk of material misstatement. But then the others would make the cut. These are the risks now that my client needs an internal control over. These are the things that they need to prevent or at least detect and correct on a timely basis. So, again, maybe go through that brainstorming exercise with members of your engagement team and so that you get better at this brainstorming activity.

Once you do it for a particular client one year, it makes it really easy in the subsequent years because all you have to do really is go get an update to that process narrative. OK. Make sure, again, that you do that process walkthrough to make sure that there, we do more than just inquiry, that we still have that accurate representation of the process. Then think through what are the relevant assertions, and then brainstorm. OK. Your brainstorming has already been done in a prior year. All you would need to do is make sure that those are still the appropriate risks and then you would then again match up those same client controls to those particular items. If we had a control deficiency in a prior year, maybe my client has actually implemented an internal control that we can now start to utilize as part of this design work. OK.

So that's how we go about identifying those control objectives in this top down risk-based approach. OK. Now, as I just mentioned, now that we've identified these risks or these control objectives, whatever you or your firm wants to call them. OK. And, I've kind of referred to it as both. Right. I prefer to call them risks, OK, or "what could go wrongs?" Other firms actually call them the control objectives. OK. They mean the same thing. OK. What does my client need a control for? Now we want to identify those key controls then that would address each material risk. Now notice the word here, "key controls," because your client might have 100 controls out there that would address that material risk, but I might say, hey, out of those hundred, I'm happy with those three. Those are the key controls. Professional judgment helps you determine what those are. OK.

So this is where we get into the realm of those activity-level controls as opposed to the entity-level controls that we discussed earlier. So the activity-level controls is the information, these are all those different documented policies and procedures where they initiate, record, process, and report those transactions and the control activities themselves, which are all the different things that the people or the computer system does that would prevent or detect and correct on a timely basis these material errors or frauds that would get into that system. We see here in the third bullet point, these things typically include things like authorization controls, proper segregation of duties, safeguarding of assets, and various reconciliations that are out there. These often times have really good chances of being the primary key controls. We want to kind of start with those and see if those are enough, and if they are we can stop. But if we need more controls, we continue to look for additional controls.

Remember our discussion a little bit earlier, the difference between an activity-level control and an application control is simply an activity-level control - what the computer system is actually doing instead of a person. Now there is one big benefit to the utilization and the identification of an IT application control as a key control. OK. If you take the additional presentation called "Testing the Operating Effectiveness of Internal Controls," we talk about sample sizes and how many items you would need to test in order to test the operating effectiveness of the key controls over the period. And one of the benefits of an IT application control is that our sample size, OK, in those particular items, is one. OK. Right. Because the computer system is going to do it the same way every time. How do you know this? Well, because you've already looked at the IT general computer controls. You know from an IT entity-level, control level, that the computer system does what it's supposed to do. So now my sample size simply is one. So in a few minutes we're going to be talking about verifying the implementation of these key controls by looking at one instance. So in this case, if you do a verification of implementation of an application control, you've already done the test of operating effectiveness of that same control. OK. So just something to keep in mind as we're dealing with these various levels of types of controls that are out there.

OK. So as I mentioned just a moment ago, when we're considering the key controls only, remember a company might have hundreds of controls in place. We only want to focus on those controls that are related to financial reporting, remember, within the significant classes of transactions and we want to use our professional judgement to identify the most important control, the ones that deal with the most material risks within each class of transaction. Identify the most effective controls related to those risks, starting with the entity-level controls and then working our way down this hierarchy into the activity-level controls, remembering to stop when we're satisfied that the right controls have been identified. OK. So that's the difference between the risk-based and the top down components. They work together. OK.

So for example, if these were our risks or our audit objectives over here on the left hand side, this particular auditor identified six different controls. But I like the way that they documented these. We can see here easily that controls five and six, if they're in place, right, they take care of every risk that's over here. So it's great that they have all these other controls over here. These are great. I'm happy. But these are the ones that become the key controls. OK. Now could I say, hey, all of these are key? Absolutely, you could. Right? For example, if we were to say, hey, you know what, let's say that this particular control, or if this X right here was not there, we would need to say, hey, control two needs to come into play now because it's the only one that satisfies control objective number five.

Here's an example from a set of real workpapers. This particular auditor, looks like they were doing some test work on revenues, again, it looks like. And so they took all of their different assertions. They had a brainstorming session of what could go wrong. These are all the things that they identified that could create a material error or material fraud in those assertions. And notice that they identified 18 different controls, OK, that would mitigate all those various items. But when they looked at it closer, the ones that are highlighted in yellow took care of all the different risks. And so those one, two, three, four, five, six, seven controls became the key controls. OK. So they were able to narrow it down to seven. Hey, Chris, why is that important? Why don't I just call all 18 controls? Well, you can, but remember, now we're going to have to go verify the implementation of the controls that we identify as key, so 18 versus seven. And if we decide that we want to test the operating effectiveness of these controls, I would have to test 18 versus test seven. OK. Now often times the ones, again, that we identify as being the key controls are sometimes these higher level controls. Remember the top down approach. So if I'm using a monitoring control, let's say that I'm looking at, I had a client that ties back into the exercise we just did. My client was a steel company in Savannah, GA. And the owners of the company, this husband and wife, they knew all of the customers personally. Right. They knew who bought their product from them. So every month one of the controls that they had is they just flipped through the monthly sales report and they looked to see, hey, does anything look kind of weird or suspicious? And if they noticed a new customer, for example, well they would go to those salespeople and be like, who is this Chris Company? We don't know them. Right. Why are they buying this material amount of goods from us? Who are they? I want to meet them, those kind of things. So they had a real handle on those various sales. So it didn't really matter if they had a database or if that database was protected, etcetera. Those particular owners are going to catch a material error or material fraud simply from that monthly review of that monthly sales report. So I asked myself, how many times a year does that control happen? Well, it's monthly, so it only happens 12 times per year. So my sample size is going to be very, very small in testing the internal controls related to that revenue recognition issue. OK. Versus if I had a control, let's say it was number 13 here, OK, yeah, it takes care of these risks, but let's say it happens 10,000 times a year. That's a very large population. So ultimately, if I want to test the operating effectiveness of those, I probably have to test 90 of these controls and 90 of this one. Right? So all of a sudden testing controls doesn't seem too attractive to me because it's going to take a lot of time and a lot of effort to test those two controls. Right. So oftentimes using this top down risk-based approach makes us more effective and more efficient.

So again, just a real quick reminder that these key controls often consist of those management review controls that I just talked about, those information technology general computer controls, and then at the activity level, things like authorizations, reconciliations, and remember those application controls. Notice, only when the ITGCs are effective, right, which would result in a sample size of one. OK. All right. Hopefully that helps the understanding.

Now the entity-level control precision affects the consideration as key control. So if you want to use one of these higher level controls, like a monitoring control, for example, right, we need to make sure it falls into this green area, that the control is precise enough and it's direct enough. For example, I wouldn't want to say, oh, those salespeople would never create a fictitious customer because they have an, an ethics statement in their control environment. They have a code of conduct and those salespeople know that it's wrong. So that's good enough for me to say, hey, that would never happen. And probably not direct enough. Right. It's precise maybe, but it's not direct enough for me to be able to rely on it. So you want to use some professional judgment in determining which ones are, again, direct and precise enough to really be something that would prevent or detect and correct that potential error or fraud on a timely basis.

OK. Now that we've identified those controls, OK, let's say in that last example, in those real workpapers, we have those seven identified key controls out of the 18. Remember, now we have to do more than just inquiry. The client told us they have those. Let's now do the GAAS step requirement number two, verify that those controls have been implemented. OK. So this is the nature of the timing and extent of the verification of implementation procedures. OK. Remember, we're going to ask the client, hey, do you do it? Oh, yeah, yeah, Chris, this is what we do on every transaction. OK. Great. I trust you. But let me verify it. Let me observe it. Let me inspect for evidence of it. Maybe you let me re-perform it. OK. So these are the four different steps that you can utilize to verify the implementation of those key controls. OK. It's as simple as that. It doesn't have to be any harder than that. How many? One. When do I do it? At the execution of the control. Right. I'm going to go out there today and see if that control actually exists. Let's go see what we have today. Right. So typically it's at the execution of the control. Now, a lot of firms, OK, that I work with, they'll perform something called a controls walkthrough. And there's nothing wrong with doing a walkthrough. It is a way to verify the implementation of key controls. But the way that a walkthrough works is the auditor would go select a transaction and then follow that transaction all the way through the process, watching, OK, inspecting, maybe re-performing all the various controls that happened to it as it makes its way through that entire process. OK. I think a walkthrough is a really great thing to do if you're working with a lot of different types of controls. But let's say for example, that within the revenue recognition cycle, my key control is that owner's monthly review. Well, that's not even really a walkthrough-able. Why would I want to take a transaction and follow a transaction through ultimately to see, hey, the owners are reviewing that monthly sales report. Why don't I just go directly to the monthly sales report, maybe observe them doing it, maybe get one and see if maybe they've signed off on it. Right. Hey, I did it. Or they put a stamp on it that says reviewed, or maybe there's highlights and notes that indicate that they really did a review. That's what's going to give me confidence as an auditor that, OK, I think they're telling me the truth that that control is in place. So if you do a walkthrough, it's perfectly acceptable. I personally and professionally think that many, many times a walkthrough is a very inefficient way to go about doing it. Personally, I just take my key controls. I go directly to that control performer and I talk to them, I observe it, I inspect for evidence of it, OK, I maybe re-perform that. OK. And that's perfectly acceptable according to generally accepted auditing standards. Pick which one makes the most sense for you.

OK. So if you do use a walkthrough, and again because they're very common, I wanted to make sure that we had at least a slide that addresses them. Right. Remember, we're going to be following a transaction through the transaction cycle. It helps us confirm our understanding of the client's processes. Love that. Right. As a matter of fact, earlier I mentioned actually doing a process walkthrough. Now the reason that I like to do a process walkthrough earlier is because it would really suck to me, right, to go through all this brainstorming, all this matching up of internal controls, etcetera, and when I ultimately go out to do my processing controls walkthrough, I find out, oh, this isn't really the way it always happens. Oh, they do something different in this particular situation. So now I basically have to go back to the beginning, update my process narrative, reconsider those relevant assertions, re-brainstorm to include those additional processes that I didn't know about, match up those additional internal controls, and then verify the implementation. So I kind of want to do it right the first time. So I want to make sure that I personally start with a good process narrative in the very beginning. OK. But again, a lot of firms will do the process and the controls walkthrough together. Maybe in a subsequent year or maybe two or three years down the road, maybe a walkthrough becomes more and more attractive because I now know what this process is all about. But I still probably wouldn't be a fan of it. I'd rather just go directly to those key controls and verify the implementation of those various items. Now again, if we're using a walkthrough, though, it does allow verification of implementation via observation and inspection, maybe re-performance, it counts as a test of one occurrence, which is also again, remember is the sample size when dealing with application controls. So if you and your engagement team ultimately decide, hey, we would like to test the operating effectiveness of the key controls over this particular cycle, just remember, if your sample size came out to let's say 20, well, you've already done one. You did it when you did your walkthrough. You've already seen that control working once. The biggest difference between this verification of implementation and the test of operating effectiveness is the verification of implementation only gives you limited evidence and it tells you that that control is real. You saw that it is in place. The test of operating effectiveness says, hey, there's evidence the client has been doing it throughout the year. OK. So if I were to go out today and go to that order entry person and see that he or she is comparing that sales order to that approved customer database, I know it's real. Now I wonder if they were doing that last January? What about in February? What about in April? What about in October or December of this year? Right. So I would need to verify that it's been happening throughout the entire year. OK. So if you decide to test the operating effectiveness, it simply is an expansion of what you're doing to verify the implementation. Right. Remember we have to keep in mind the impact of those general computer controls because let's say that those owners are reviewing those monthly sales reports or the departmental manager is reviewing their biweekly payroll report, etcetera. Do those reports have some level of validity? What have we done through the ITGC work to make sure that all those different reports that they're relying on to perform those controls are reliable. OK. We can't just put blinders on and say, oh, it came out of their system, so obviously it's right. OK. We can't just pass that buck anymore. As auditors SAS 145 says, you got to now do something to verify that information.

Now, as I mentioned, if you decide to perform a walkthrough, you're going to select one transaction. You're going to follow that transaction through the process from the initiation point through its termination point, ultimately to the general ledger, and ultimately then to the financial statements. We're going to be verifying the implementation of only the key controls, asking ourselves, does this control exist? Is the client doing it? How many times? One time.

Right. Typically the day that I'm there. So a lot of times this might be an observation. Remember though, the limitations of performing an observation, that person may be only performing that control because they know you're there watching them. Right? You're looking over their shoulder, or they're at least more diligent about doing it because you're there. So you might also want to maybe inspect for evidence, OK, maybe they put a tick mark or again, a stamp or sign off. Maybe you just pick a different transaction as well and just do a different step, verification step, to make, actually make sure that they really are doing that particular control. Now those walkthrough inquiries, then talk to those personnel who actually do the procedures. So don't just do your walkthrough with the controller. Right. Understand their understanding of what's required, OK, and whether those procedures are always performed that way. Are there any one-offs? What do you do when? OK. Ask about the consistency or the one offs or the workarounds. If you were to get around this one, how might you do it? Right. So we can build in some fraud-related types of questions into this interview as well. Consider those fraud-related questions and remember, corroborate. Don't just take their word for it. Inspect, observe, possibly re-perform. OK.

Now that we have gone through the design and implementation work, OK, we might have identified some controls that are missing or controls that are there, but, in our professional judgment, they're not good enough. Right. I wish there were more. I wish there was a stronger control. Now, this is all based on your professional judgment. So anytime we have a question like that, there's going to be what we call a control deficiency. We can have a design deficiency. So a missing control or a poorly designed control. I could have an implementation deficiency. Hey, the control sounded good or it looked good on paper, but when I went out to actually verify its implementation, there was no evidence that that was happening. Or we ultimately, if we tested the operating effectiveness, we could have an operating deficiency. Now regardless of the type, whichever category you want to put it in, a deficiency means that there's a hole in that filtration system, an error or fraud can get through. OK. So anytime we have these, notice what we have to do, we're going to report those to management for remediation. Hey, we got a problem, you need to fix this. Discuss it with our engagement team members. Let's raise a red flag and say, hey, did you guys know that we've got an internal control deficiency? Because that's going to have an impact on our work programs. Right. We might identify some additional risks. It might impact materiality. It might impact other high level audit adjustments that we have. We probably need to do some additional substantive test work on those particular areas. Now if they're effectively designed and implemented, consider then testing the operating effectiveness of those same key controls for those higher risk relevant assertions. So for the areas where you're planning to do a lot of test work, substantively, maybe there's a real cost benefit now to expanding this implementation work to test the operating effectiveness of it. OK. So you don't have to recreate the wheel, you just take those same key controls, you take that same work that you did to verify implementation, and now you just expand it to be throughout the period. OK. And again, if you take the top down risk-based approach, if you use those higher level types of controls, they probably operate less frequently, so you have smaller population sizes. OK. And so therefore, you wind up with smaller samples, OK, in your test of controls. Now we're talking about sampling here. Right. The AICPA has an audit sampling guide. And in that sampling guide, they have all kinds of different tables for test of control sampling and for substantive audit procedure types of sampling. We do have another webinar within Checkpoint Learning on audit sampling. OK. So make sure that you sign up for that one and you're going to get a lot of useful information on how to be more effective and efficient at sampling, again, whether that's substantive sampling or sampling within test of controls. All right. So again, if we use that top down risk-based approach, we're going to have smaller population sizes. So therefore we wind up with smaller sample sizes. OK. As an example, if you were to go to the AICPA audit sampling guide today, we would see it says, hey, if you have a monthly control, you have to test two to four. If you have a weekly control, there's 52 in that particular population, you have to test five to eight. Right. So it makes it a lot easier and a lot more attractive to us as auditors to possibly test those controls so that we can then rely on them a little bit more in order to reduce the amount of work that we have to do substantively. OK.

Now that we have done that GAAS required understanding of internal controls, again, assessing design, verifying the implementation of those key controls, what do we do with that? Well, I harkened on this a little bit earlier. Now we decide, do we want to test the operating effectiveness of those key controls? OK. Easy enough. Right.

So that brings us back to our learning objectives. Right. You should now be able to explain the GAAS requirements to understand those internal controls for a non-public and or a public entity. At this point we can identify the significant transaction cycles. We know that there's two already on our list ,and we use our professional judgement and our understanding of the audit risk model, OK, to brainstorm and identify any relevant assertions and or risks of material misstatement that's going to create another significant transaction cycle. We now know that we take those significant cycles and we brainstorm by relevant assertion to identify the control objectives or the risks. We then match up the client's internal controls to those risks and then we determine, of those, which ones are the key controls. And then we have to go beyond just inquiry and we have to inspect, observe, and or re-perform in order to verify the implementation of those key controls. And we know that we have to identify, communicate, and respond to any design or verification deficiencies because we know that that creates a hole in the filtration system. The client isn't preventing or detecting and correcting. So now as an auditor, we have to be on the other side of that filter with our audit work programs so that we can test to see if those particular risks manifested themselves in the clients general ledger. Easy enough. Right. Again, I think you're going to learn a lot as you get more and more involved in this internal control system. It makes you a smarter auditor. So therefore, again, you can work smarter rather than working harder. There's a huge benefit in this. OK. We can also add a lot of value to our clients by highlighting areas where they can improve their own internal controls. And that has an added benefit to us in future years. As my client remediates their deficiencies, we begin to get to the point where we can rely on more and more so that we can ultimately start to test those controls and reduce the test work that we have to perform through our work programs.

OK. So there's that case study potential risks answer key.

And here's that LinkedIn profile link that I mentioned a little bit earlier. Please join me there if you have any questions, again, on this particular topic. I will be happy to address those on a pretty timely basis with you. Just shoot me a message there in LinkedIn.

All right. I want to thank you so much for being here. I hope you enjoyed the presentation. I hope you learned a lot. I hope you feel more comfortable in the GAAS requirement to understand these internal controls and you feel like maybe you can then share this information with other members of your engagement team.

GROUP STUDY MATERIALS

A. Discussion Questions

1. Why is understanding internal controls so crucial in assessing the risk of material misstatement during an audit? Can you think of a scenario from your own practice where this understanding made a difference?

2. How does SAS 145 redefine the way we assess inherent risks and significant transaction cycles? What adjustments have you made in your risk assessment process based on these changes?

3. How do you ensure that the entity-level controls, such as management's integrity and the control environment, are strong enough to rely on? Have you ever had to challenge a client's control environment?

4. When verifying the implementation of key controls, which method (inquiry, observation, inspection, re-performance) do you find most effective, and why? Can you provide an example from an audit you've worked on?

5. What are some signs of poorly designed internal controls that you've observed in your audit practice? How did you address these with the client?

6. How does professional judgment come into play when identifying key controls for significant transaction cycles? Can you share an instance where your judgment significantly affected the outcome of an audit?

B. Suggested Answers to Discussion Questions

1. Internal controls help mitigate the risk of errors or fraud making their way into the financial statements. By understanding the client's internal control system, auditors can better assess where potential risks of material misstatement could arise. This understanding also helps auditors tailor substantive testing and ensure they focus on high-risk areas.

2. SAS 145 clarifies the definitions of inherent risks, significant transaction cycles, and relevant assertions. It emphasizes a top-down, risk-based approach, which starts with identifying entity-level controls and works downward, ensuring that significant transaction cycles are evaluated based on their potential impact on material misstatement. This framework encourages auditors to prioritize areas where the risk of material misstatement is high.

3. Evaluating management's tone at the top and overall corporate culture is key. This involves assessing factors like management's commitment to ethical practices, transparency in financial reporting, and the quality of internal communication. Auditors may conduct interviews with key personnel, review corporate governance policies, and observe management's interactions with various departments.

4. Each method has its value depending on the situation. Inquiry helps gain initial insights, but observation and inspection provide more concrete evidence that controls are actually functioning. Re-performance can be most reliable as it directly tests whether a control is working as intended. For critical controls, a combination

5. Signs include lack of segregation of duties, inadequate documentation or record-keeping, vague or overly complex control procedures, and inconsistent application of controls. Poor design often leads to higher risk areas where errors or fraud can occur without detection, and it usually necessitates recommending improvements to management.

6. Professional judgment is crucial when determining which controls are most effective at addressing specific risks. Auditors must evaluate the size, complexity, and specific risks associated with a client's transaction cycles. They also need to decide whether the controls are capable of preventing or detecting material misstatements, based on both their design and implementation.

GLOSSARY

AICPA—American Institute of Certified Public Accountants

Analytical Procedures—Evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures range from simple comparisons to the use of complex models involving many relationships and elements of data, varying from comparisons to ratios to trend analysis.

Control Environment—Foundation on which an effective system of internal control is built and operated in an organization.

COSO Framework—The Committee of Sponsoring Organizations (COSO) was the group that sponsored the National Commission on Fraudulent Financial Reporting (the Treadway Commission). The commission observed that a new and broader definition of internal control was needed. This led to the publication of **Internal Control—Integrated Framework**, which was published in 1992 and revised in 1994. It became the definitive literature on internal control among audit practitioners, accounting and finance executives, and managers and educators.

Engagement Team—All partners and staff performing the engagement, and any other individuals who perform procedures on the engagement, excluding an auditor's external specialist and internal auditors who provide direct assistance on an engagement.

Estimated Current Value—The amount at which an item could be exchanged between a buyer and seller, each of whom is well informed and willing and neither of whom is compelled to act.

GAAP—Generally Accepted Accounting Principles

GAAS—Generally Accepted Auditing Standards; A set of guidelines used by auditors while conducting audits of a company or other entity; it provides a uniform method of auditing to be used by accountants to ensure consistent and reliable audit results.

Inherent Risk—The risk posed by an error or omission in a financial statement due to a factor other than an internal control failure.

Internal Controls—Management's design of the risk areas and taking accountability of those business process risks, whether they're financial, operational, or system.

PCAOB—Public Company Accounting Oversight Board

Personal Financial Statements—Statement of financial condition and statement of changes in net worth for an individual, married couple, or family.

Professional Judgment—Applying relevant knowledge and experience within the context provided by relevant professional and technical standards.

Relevant Assertions—Relevant assertions for a particular audit area are assertions that have a meaningful bearing on whether the related account balances, transaction classes, or disclosures are fairly stated. For example, valuation may not be relevant to cash accounts unless currency translation is involved.

Risk Assessment—The identification and evaluation of several aspects of an entity whereby risks are identified and evaluated for use in guiding the audit procedures that will be necessary in order to substantiate the amounts reported in the financial statements.

Risk of Material Misstatement—The risk that the financial statements are materially misstated prior to audit.

Statement of Financial Condition—Lists assets and liabilities in order of liquidity for an individual or family unit.

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

1. What is the primary measurement for assets and liabilities in a personal financial statement?

   A. Book Value.
   B. Estimated Current Value.
   C. Fair Value.
   D. Historical Cost.

2. How should liabilities be presented in a personal financial statement?

   A. At estimated current value.
   B. At fair value.
   C. At the amount necessary to settle the debt.
   D. In order of maturity.

3. What is the correct order of asset presentation on a Statement of Financial Condition?

   A. Real estate, Cash, Marketable securities.
   B. Cash, Marketable securities, Real estate.
   C. Cash, Real estate, Automobiles.
   D. Automobiles, Real estate, Cash.

4. What should be disclosed regarding closely held businesses in a personal financial statement?

   A. Detailed list of assets and liabilities of the business.
   B. Fair value measurement level.
   C. Only the income generated by the business.
   D. Percentage of ownership and relevant information.

5. Which of the following is a required disclosure in a personal financial statement according to ASC 274?

   A. The entity for which the financial information is presented.
   B. The fair value of all liabilities.
   C. The original cost of personal property.
   D. Expected future benefits from pension plans.

Continued on next page

6. What is the purpose of assessing the design effectiveness of internal controls during a financial audit?

   A. To determine if controls can prevent, detect, and correct material misstatements in a timely manner.
   B. To ensure that fraud is impossible.
   C. To help management improve efficiency in non-financial areas.
   D. To identify which transactions should be excluded from the audit.

7. What is the primary difference between audits of public and non-public companies concerning internal control testing?

   A. Non-public companies are required to implement more stringent controls.
   B. Non-public companies must also test internal controls' operating effectiveness.
   C. Public companies are required to test operating effectiveness of internal controls.
   D. Public companies can opt out of control testing if management permits it.

8. According to the presentation, what are the four methods to gather audit evidence for verifying internal controls?

   A. Inquiry, inspection, testing, and audit.
   B. Observation, reperformance, inquiry, and inspection.
   C. Sampling, inquiry, confirmation, and audit.
   D. Testing, sampling, survey, and inquiry.

9. Which of the following is *not* one of the five COSO components of internal control framework discussed in the presentation?

   A. Control activities.
   B. Information and communication.
   C. Personnel management.
   D. Risk assessment.

10. When is it necessary to test the operating effectiveness of internal controls?

    A. When controls are implemented after the financial period.
    B. When performing a non-public company audit.
    C. When the auditor plans to rely on the controls.
    D. When the client has documented deficiencies in controls.

Continued on next page

11. What is the purpose of verifying the implementation of key internal controls?

    A. To review the operating effectiveness of controls.
    B. To ensure that controls are being modified to meet changing risks.
    C. To eliminate the need for substantive testing.
    D. To confirm that controls exist and are being used by the client.

12. Which component of the COSO framework involves management's identification of risks that could affect the achievement of objectives?

    A. Risk assessment.
    B. Monitoring activities.
    C. Information and communication.
    D. Control activities.

13. What is one of the main objectives of the COSO framework's monitoring activities?

    A. To analyze external market conditions.
    B. To ensure internal controls are consistently implemented and are effective over time.
    C. To monitor employees' daily work for errors.
    D. To provide training for new employees.

14. Why do auditors use a top-down, risk-based approach when assessing internal controls?

    A. To ensure that entity-level controls are not considered.
    B. To ensure that no controls are overlooked during the audit.
    C. To focus on areas where the risk of material misstatement is higher.
    D. To test all controls throughout the organization.

15. What is a key factor in determining whether a control deficiency is significant?

    A. Whether the deficiency was intentional.
    B. Whether the deficiency is related to a non-financial process.
    C. Whether the control has been in place for less than a year.
    D. The likelihood and magnitude of potential misstatements.

CPE Network®
Accounting & Auditing Report
Volume 37, Issue 9 **October 2024**

Subscriber Survey

Evaluation Form

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

How would you rate the topics covered in the October 2024 **CPE Network® A&A Report?** Rate each topic on a scale of 1–5 (5=highest):

	Topic Relevance	Topic Content/ Coverage	Topic Timeliness	Video Quality	Audio Quality	Written Material
Personal Financial Statements	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|
Gaining an Understanding of Internal Controls	|_______|	|_______|	|_______|	|_______|	|_______|	|_______|

Which segments of the October 2024 issue of **CPE Network® A&A Report** did you like the most, and why?

____

____

____

____

Which segments of the October 2024 issue of **CPE Network® A&A Report** did you like the least, and why?

____

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____

____

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

____

____

____

____

How would you rate the effectiveness of the speakers in the October 2024 **CPE Network® A&A Report?** Rate each speaker on a scale of 1–5 (5 highest):

	Overall	**Knowledge of Topic**	**Presentation Skills**
Kurt Oestriecher	|______|	|______|	|______|
Chris Martin	|______|	|______|	|______|

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

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

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

Were program materials accurate? Yes ☐ No ☐ ____________________________________

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

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

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

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

Specific Comments: ____

Name/Company ____

Address ____

City/State/Zip ____

Email ____

Once Again, Thank You…

Your Input Can Have a Direct Influence on Future Issues!

CPE Network®

CPE Group Attendance Sheet

Firm/Company Name: ____________________

Account #: ____________________

Location: ____________________

Program Title: CPE Network Accounting and Auditing Report, October 2024 Date: __________

Name	Email	Total Hrs	IRS PTIN ID (if applicable Tax only)	Sign In	Sign Out

I certify that the above individuals viewed and were participants in the group discussion with this issue/segment of the CPE Network® newsletter, and earned the number of hours shown.

Instructor Name: ____________________ Date: __________

E-mail address: ____________________

License State and Number: ____________________

CPE Network/Webinar Delivery Tracking Report

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

			First CPE Hour			CPE Hour 2			CPE Hour 3			FOR TR USE ONLY
First Name	**Last Name**	**Student Email**	**Poll 1**	**Poll 2**	**Poll 3**	**Poll 1**	**Poll 2**	**Poll 3**	**Poll 1**	**Poll 2**	**Poll 3**	**Certificate Issued?**

CHECKPOINT LEARNING NETWORK

CPE NETWORK®
USER GUIDE

REVISED December 31, 2023

Welcome to CPE Network!

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

This User Guide has the following sections:

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

IMPORTANT: This User Guide outlines in detail what is required for each of the 3 formats above. Additionally, because you will be delivering the training within your firm, you should review the Sponsor Responsibilities section as well. To get certificates of completion for your participants following your training, you must submit all the required documentation. (This is noted at the end of each section.) Checkpoint Learning Network will review your training documentation for completeness and adherence to all requirements. If all your materials are received and complete, certificates of completion will be issued for the participants attending your training. Failure to submit the required completed documentation will result in delays and/or denial of certificates.

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

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

We are happy that you chose CPE Network for your training solutions.
Thank you for your business and HAPPY LEARNING!

Copyrighted Materials

“Group Live” Format

CPE Credit

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

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

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

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

Advertising / Promotional Page

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

Monitoring Attendance

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

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

Real Time Instructor During Program Presentation

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

Elements of Engagement

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

Make-Up Sessions

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

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

Awarding CPE Certificates

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

Subscriber Survey Evaluation Forms

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

Retention of Records

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

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

Finding the Transcript

Note: DVDs no longer ship with this product effective 3/1/2023.

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- https://get.adobe.com/reader/

The entire transcript is also available as a pdf in the Checkpoint Learning player in the resource toolbox at the top of the screen, or via the link in the email sent to administrators.

Requesting Participant CPE Certificates

When delivered as 3 CPE credits, documentation of your "group live" session should be sent to Checkpoint Learning Network by the following means:

Email: CPLgrading@cerifi.com

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

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

Incomplete submissions will be returned to you.

"Group Internet Based" Format

CPE Credit

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

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

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Advertising / Promotional Page

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

Monitoring Attendance in a Webinar

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

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

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

Examples of polling questions:

1. You are using **Zoom** for your webinar. The moderator pauses approximately every 15 minutes and asks that participants confirm their attendance by using the “raise hands”

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

Additional Notes on Monitoring Mechanisms:

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

Real Time Moderator During Program Presentation

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

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

Make-Up Sessions

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

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

Awarding CPE Certificates

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

Subscriber Survey Evaluation Forms

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

Retention of Records

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

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

Finding the Transcript

Note: DVDs are no longer shipped effective 3/1/2023

When the DVD is inserted into a DVD drive, the video will immediately begin to play and the menu screen will pop up, taking the entire screen. Hitting the Esc key should minimize it to a smaller window. To locate the pdf file of the transcript either to save or email to others, go to the start button on the computer. In My Computer, open the drive with the DVD. It should look something like the screenshot below. The Adobe Acrobat files are the transcript files. If you do not currently have Adobe Acrobat Reader (Mac versions of the reader are also available), a free version of the reader may be downloaded at:

- https://get.adobe.com/reader/

Alternatively, for those without a DVD drive, the email sent to administrators each month has a link to the pdf for the newsletter. The email may be forwarded to participants who may download the materials or print them as needed.

Requesting Participant CPE Certificates

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

Email: CPLgrading@CeriFi.com

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

Form Name	**Included?**	**Notes**
Advertising / Promotional Page		Complete this form and circulate to your audience before the training event.
Webinar Delivery Tracking Report		Use this form to track the attendance (i.e., polling questions) during your training webinar.
Evaluation Form		Circulate the evaluation form at the end of your training session so that participants can review and comment on the training. Return to CeriFi any evaluations that were completed. You do not have to return an evaluation for every participant.

Incomplete submissions will be returned to you.

“Self-Study” Format

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

Self-Study—Email

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

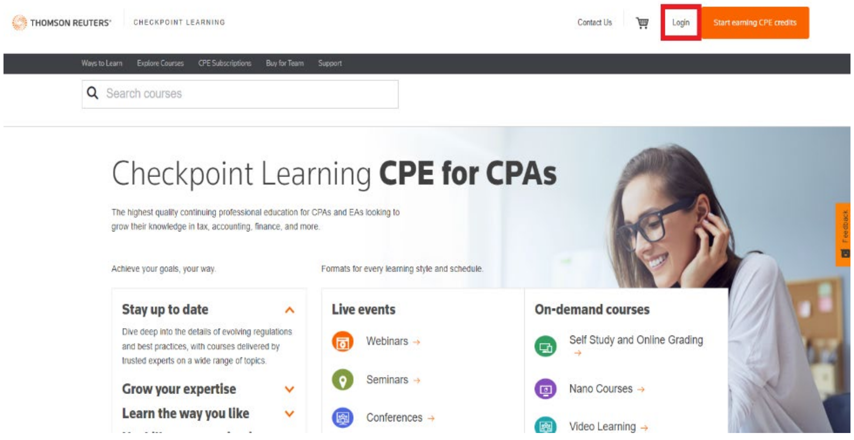
- Watch the video.
- Review the supplemental materials.
- Read the discussion problems and the suggested answers.
- Complete the quizzer by filling out the bubble sheet enclosed with the transcript package.
- Complete the survey. We welcome your feedback and suggestions for topics of interest to you.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

  CPLgrading@cerifi.com

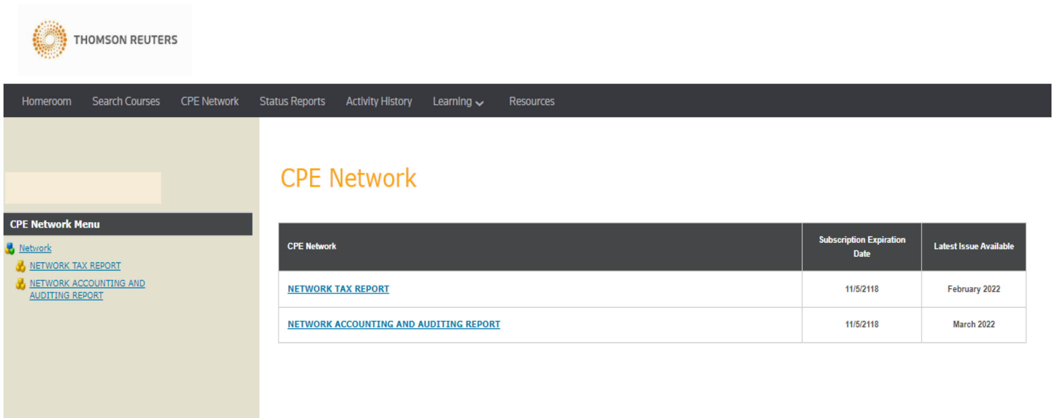
Self-Study—Online

Follow these simple steps to use the online program:

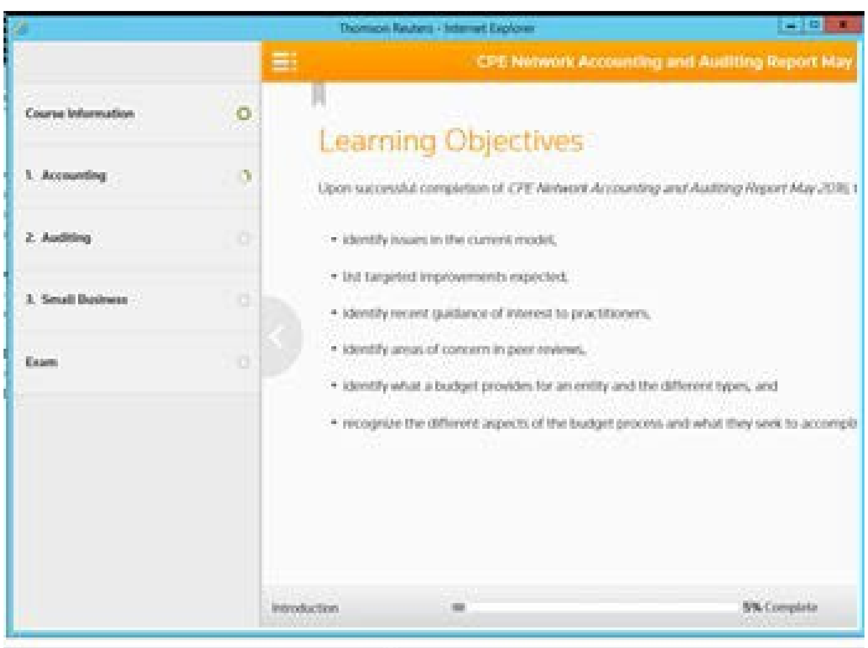
- Go to www.checkpointlearning.thomsonreuters.com .
- Log in using your username and password assigned by your firm’s administrator in the upper right-hand margin (“Login or Register”).



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

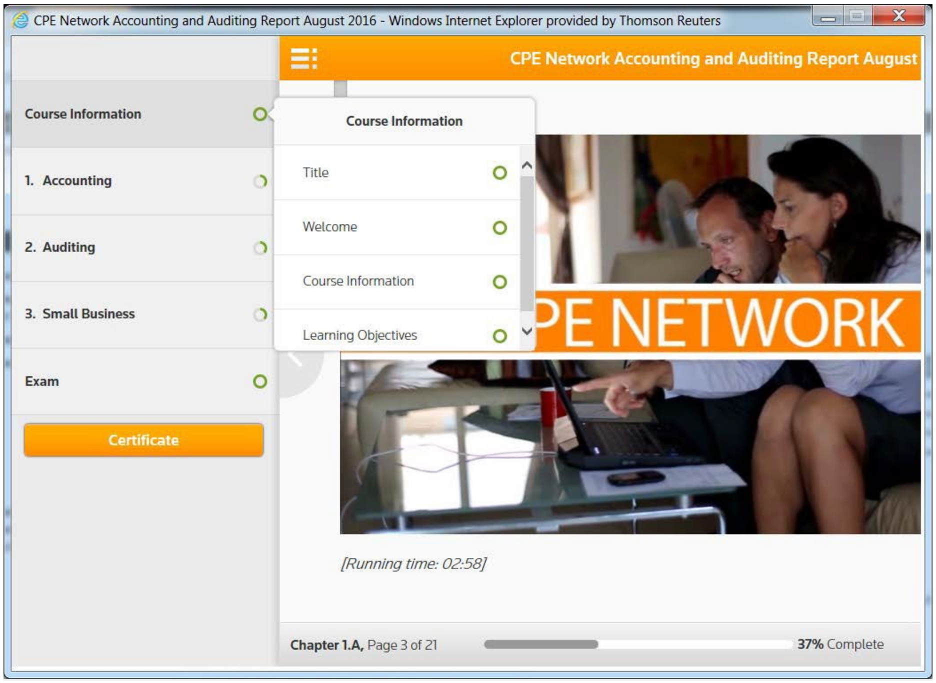


The Chapter Menu is in the gray bar at the left of your screen:

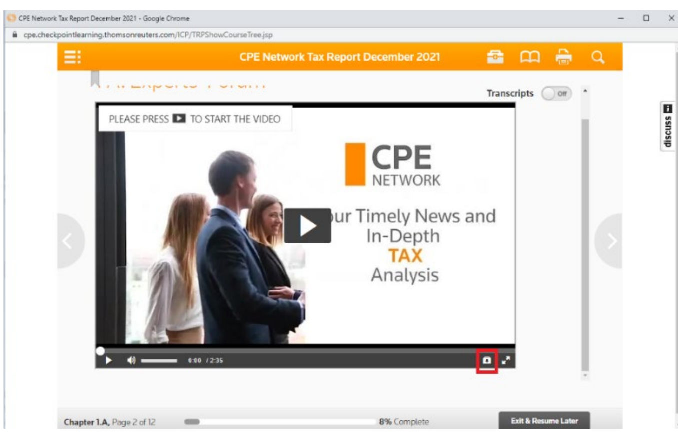


Click down to access the dropdown menu and move between the program Chapters.

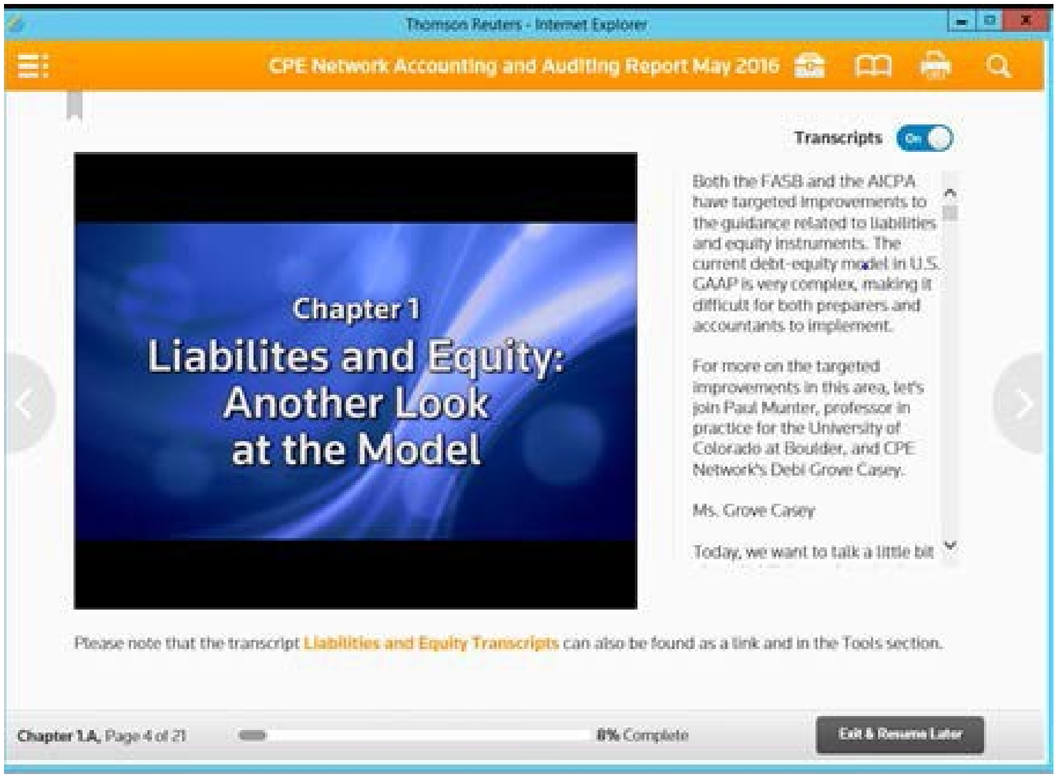
- **Course Information** is the course Overview, including information about the authors and the program learning objectives



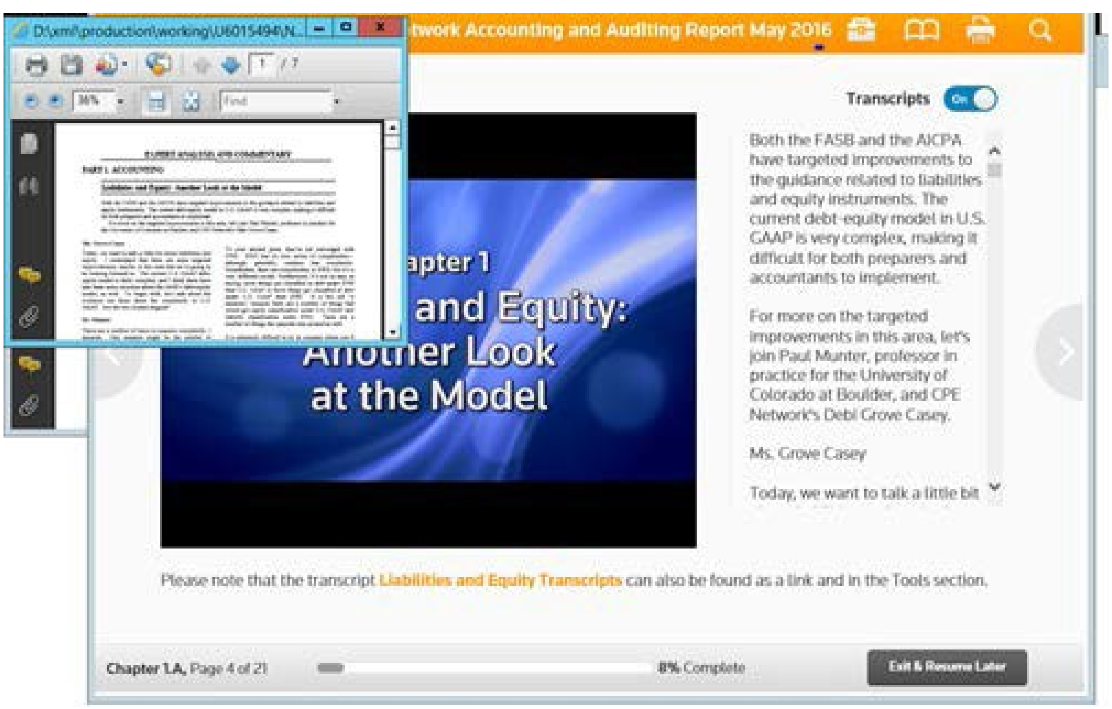
- **Each Chapter is self-contained.** Each chapter contains the executive summary and learning objectives for that segment, followed by the interview, the related supplemental materials, and then the discussion questions. This streamlined approach allows administrators and users to more easily access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



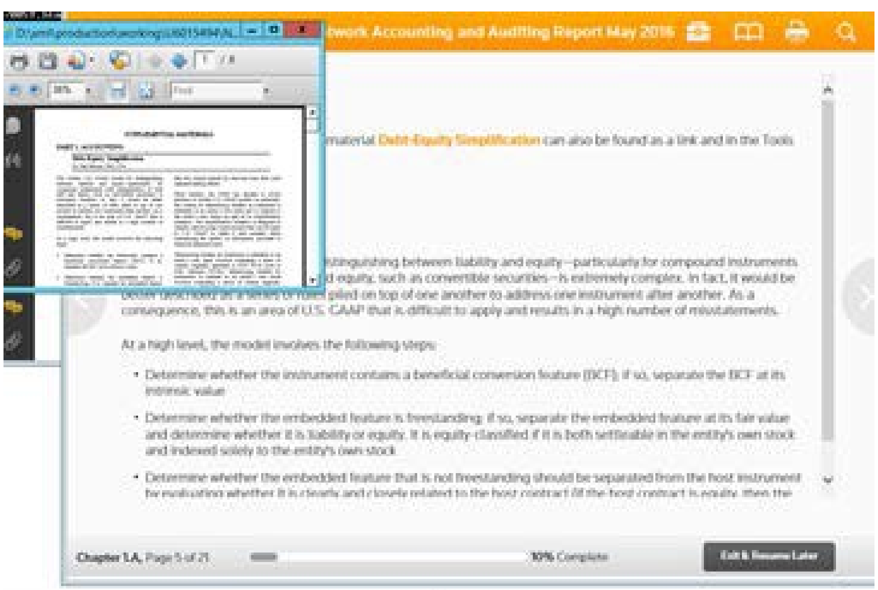
Video segments may be downloaded from the CPL player by clicking on the download button. Tip: you may need to scroll down to see the download button.



Transcripts for the interview segments can be viewed at the right side of the screen via a toggle button at the top labeled **Transcripts** or via the link to the pdf below the video (also available in the toolbox in the resources section). The pdf will appear in a separate pop-up window.



Click the arrow at the bottom of the video to play it, or click the arrow to the right side of the screen to advance to the supplemental material. As with the transcripts, the supplemental materials are also available via the toolbox and the link will pop up the pdf version in a separate window.



Continuing to click the arrow to the right side of the screen will bring the user to the Discussion p roblems related to the segment.

The Suggested Answers to the Discussion Problems follow the Discussion Problems.

CPE Network Accounting and Auditing Report July 2016

Suggested Answers to Discussion Problems

1. ASC 320 requires that, at acquisition, an enterprise classify debt and marketable equity securities into one of three categories:

    - Held-to-maturity
    - Trading
    - Available-for-sale

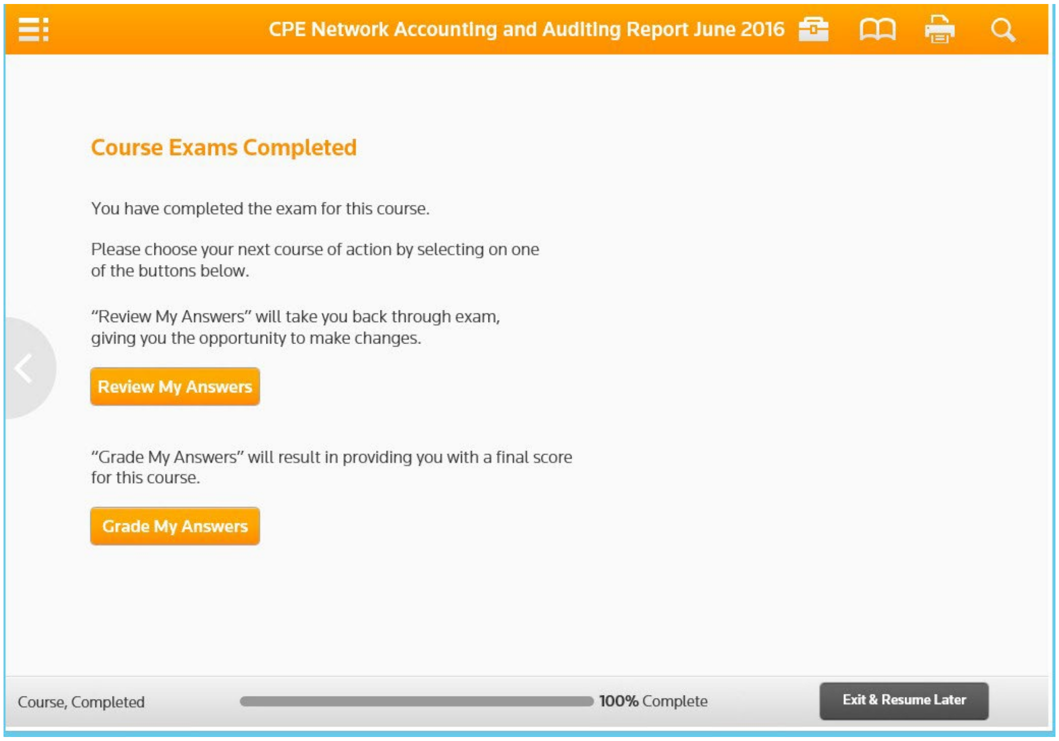
    An entity decides how to classify securities based on its intended holding period for each individual security, using the framework in ASC 320. In establishing its intent, an entity should consider relevant trends and experience, such as previous sales and transfers of securities. Classification decisions should be made at acquisition and, preferably, formally documented. It is not appropriate to use "hindsight" to classify securities transactions, perhaps by considering changes in value after acquisition.

2. The trading securities category includes securities that are bought and held principally for the purpose of selling them in the short term. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. "Short-term," in this context, is intended to be measured in hours and days, rather than in months or years, according to ASC 320. However, an entity is not precluded from classifying as trading a security it plans to hold for a longer period, as long as that designation occurs at acquisition.

3. Impairment is recognized in earnings when a decline in value has occurred that is deemed to be other than temporary, and the current fair value becomes the new cost basis for the security. An investment is considered to be impaired if the fair value of the investment is less than its cost basis. Cost includes adjustments made for

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

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



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

Additional Features Search

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

Search Results are displayed with the number of hits.

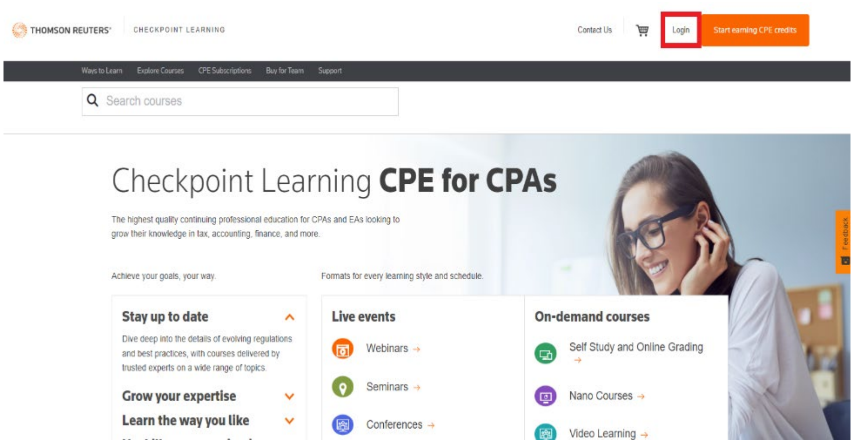
Print

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

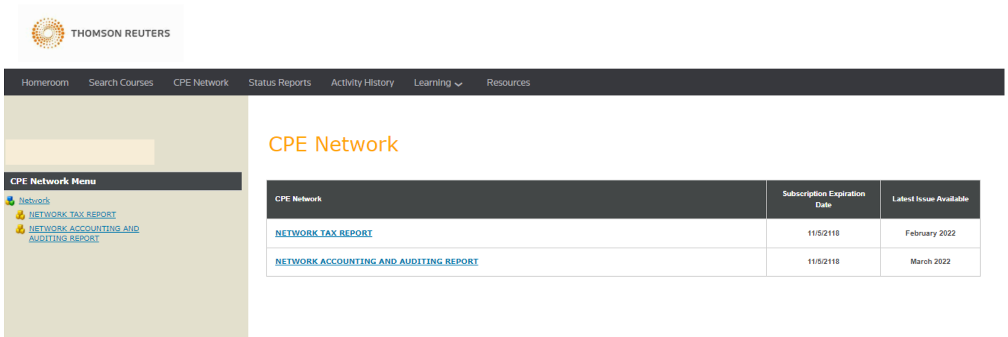
Transitioning From DVDs

Follow these simple steps to access the video and pdf for download from the online platform:

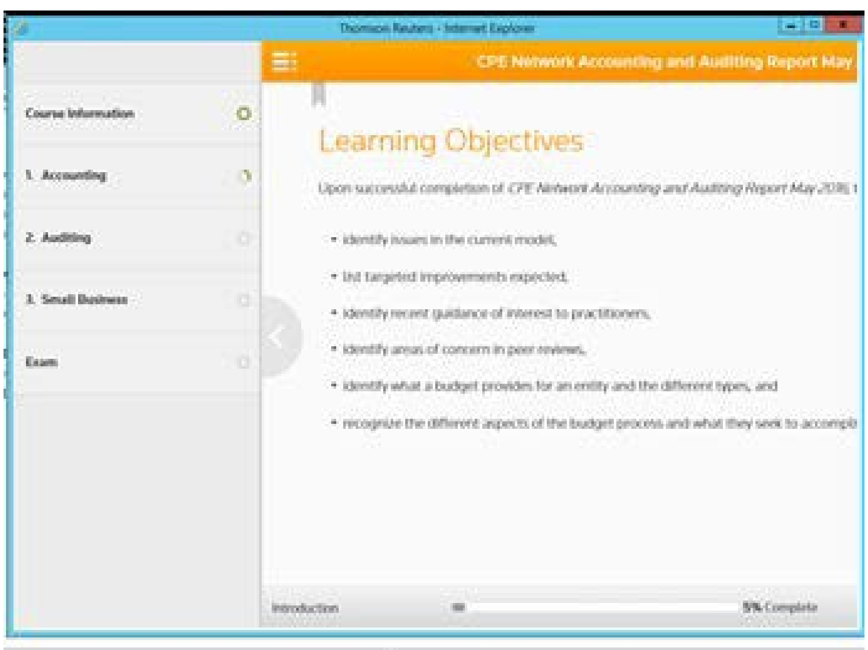
- Go to www.checkpointlearning.thomsonreuters.com .
- Log in using your username and password assigned by your firm's administrator in the upper right-hand margin ("Login").



- In the CPE **Network** tab, select the desired Network Report by clicking on the title, then select the appropriate edition.



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



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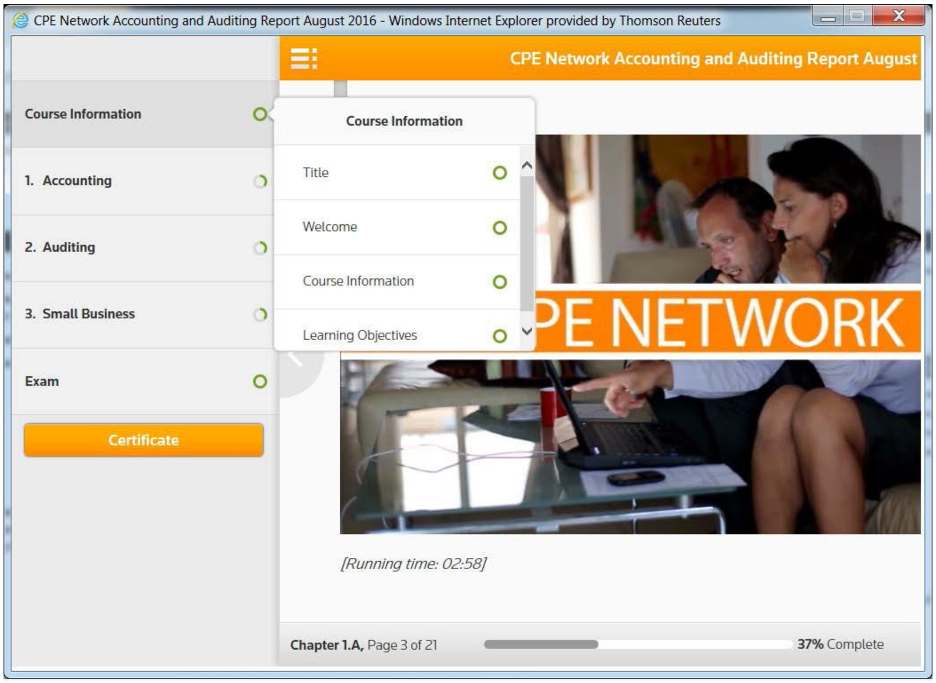
- **Course Information** is the course Overview, including information about the authors and the program learning objectives



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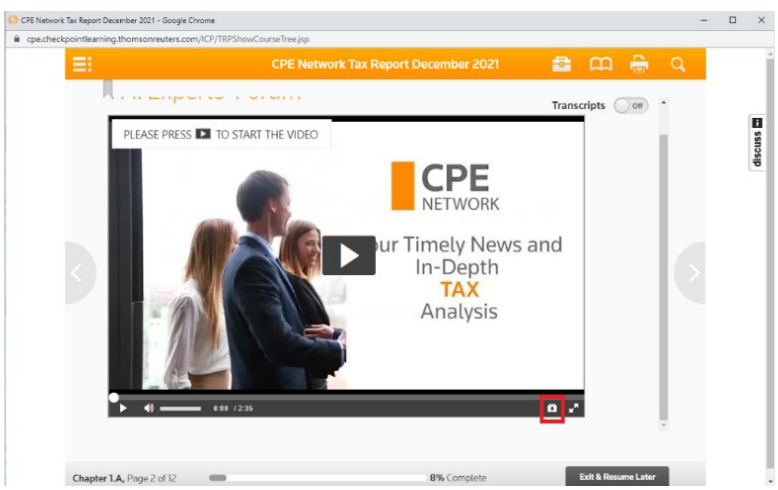

Video segments may be downloaded from the CPL player by clicking on the download button noted above. You may need to use the scroll bar to the right of the video to see the download button. **Tip: You may need to use the scroll bar to the right of the video to see the download button.**

PDFs may be downloaded from either the course toolbox in the upper right corner of the Checkpoint Learning screen or from the email sent to administrators with each release.

What Does It Mean to Be a CPE Sponsor?

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

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

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

CPE Sponsor Requirements

<u>Determining CPE Credit Increments</u>

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

Program Presentation

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

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

Disclose Significant Features of Program in Advance

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

Monitor Attendance

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

Real Time Instructor During Program Presentation

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

Elements of Engagement

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

Awarding CPE Certificates

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

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

Seminar Quality Evaluations for Firm Sponsor

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

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

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

Retention of Records

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

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

Appendix: Forms

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

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

Getting Help

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

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