

AUD Complete Study Guide

Olivia Anderson · True North Accounting & Business Solutions · Study notes for educational use. Always confirm details against the current AICPA Blueprints and authoritative standards.

Auditing and Attestation, organized by the four content areas of the 2026 AICPA Blueprint.

AREA	TOPIC	WEIGHT
I	Ethics, Professional Responsibilities and General Principles	15–25%
II	Assessing Risk and Developing a Planned Response	25–35%
III	Performing Further Procedures and Obtaining Evidence	30–40%
IV	Forming Conclusions and Reporting	10–20%

Area I: Ethics, Professional Responsibilities and General Principles

The AICPA Code of Professional Conduct

The Code is the ethical framework for AICPA members in public practice, in business, in government and in education.

STRUCTURE OF THE CODE

- **Preface:** applies to all members and contains the principles
- **Part 1:** members in public practice
- **Part 2:** members in business
- **Part 3:** other members, such as retired or unemployed members

THE SIX PRINCIPLES

1. **Responsibilities:** exercise sensitive professional and moral judgment in all activities.
2. **The public interest:** act in a way that serves the public interest and honors the public trust.
3. **Integrity:** be honest and candid, and never subordinate your judgment.

4. **Objectivity and independence:** stay free of conflicts of interest, and be independent in fact and appearance for attest services.
5. **Due care:** follow technical and ethical standards, keep improving competence and perform services diligently.
6. **Scope and nature of services:** consider the principles when deciding which services to provide.

Memory aid: "Real Professionals In Offices Do Service."

INDEPENDENCE (1.200)

Independence is required for **attest engagements**: audits, reviews, examinations and agreed-upon procedures.

Independence is not required for tax services, consulting or bookkeeping that isn't attest work. A **compilation** can be performed without independence, but the accountant's report must disclose the lack of independence.

There are two kinds of independence, and both are required:

- **Independence of mind (in fact):** actually being unbiased
- **Independence in appearance:** avoiding circumstances that would lead a reasonable, informed third party to doubt your objectivity

WHAT IMPAIRS INDEPENDENCE

Financial interests

- A **direct financial interest** held by a covered member impairs independence no matter how small. If you own ten shares of an audit client, you are not independent.
- An **indirect financial interest**, such as a mutual fund that holds the client's stock, impairs independence only if it is material to the covered member.

Family relationships

- **Immediate family** (spouse, spousal equivalent and dependents): their financial interests are treated as the covered member's own.
- **Close relatives** (parents, siblings and nondependent children): a close relative's financial interest impairs independence if the covered member knows about it and it is material to the close relative or gives the relative significant influence over the client. Independence is also impaired if a close relative holds a key position at the client, such as CFO, controller or another role with influence over the financial statements.

Employment and business relationships

- Serving as a director, officer or employee of the client, or as a promoter or underwriter, impairs independence.
- Joint ventures and material cooperative business arrangements with the client impair independence.

Loans

- Most loans to or from an attest client impair independence.
- Grandfathered loans and certain permitted loans made under normal lending terms do not. Permitted loans include automobile loans, loans fully collateralized by cash deposits, loans against the cash surrender value of an insurance policy and credit card balances of \$10,000 or less.

Nonattest services

A firm can provide nonattest services such as bookkeeping or tax preparation to an attest client only if:

- The firm does not assume management responsibilities or make management decisions.
- Management designates a qualified individual to oversee the service, accepts responsibility for the results and establishes its own internal controls.
- The firm documents its understanding with the client.

Example: You can prepare depreciation schedules, but the client must decide on useful lives and methods. You can propose journal entries, but the client must approve them.

THE CONCEPTUAL FRAMEWORK

When no specific rule addresses a situation:

1. Identify threats to compliance.
2. Evaluate the significance of each threat.
3. Identify and apply safeguards that eliminate the threat or reduce it to an acceptable level.
4. Document threats and safeguards when required.

The seven threats

1. **Adverse interest:** the CPA and client are opposed, such as threatened litigation.
2. **Advocacy:** the CPA promotes the client's position, such as promoting the client's stock.
3. **Familiarity:** a long or close relationship makes the CPA too sympathetic.
4. **Management participation:** the CPA takes on a management role.
5. **Self-interest:** the CPA benefits from a financial or other interest, such as heavy fee dependence on one client.
6. **Self-review:** the CPA evaluates work the firm performed, such as auditing records it prepared.
7. **Undue influence:** the client pressures the CPA through coercion or excessive influence.

Example safeguards: consulting another professional, a second-partner review, rotating staff off the engagement, firm quality management policies and additional training.

OTHER KEY RULES

- **Integrity and objectivity (1.100):** no knowing misrepresentation of facts and no subordinating judgment. Applies to all services.
- **General standards (1.300):** professional competence, due professional care, adequate planning and supervision, and sufficient relevant data.
- **Compliance with standards (1.310):** follow all applicable professional standards.
- **Accounting principles (1.320):** don't state that financial statements follow GAAP if they contain a material departure, unless unusual circumstances justify it and it is disclosed.
- **Confidential client information (1.700):** don't disclose without client consent. Exceptions include a valid subpoena or summons, compliance with laws, peer review and ethics investigations.

- **Acts discreditable (1.400):** for example, discrimination, harassment, negligently preparing misleading financial statements and failing to file a required tax return.
- **Advertising (1.600):** allowed if it is not false, misleading or deceptive.
- **Commissions and referral fees (1.520):** commissions are prohibited for clients for whom the firm performs an audit, review, certain compilations or an examination of prospective financial information. Otherwise they are permitted with disclosure to the client. Referral fees must be disclosed.
- **Contingent fees (1.510):** prohibited for attest clients for audits, reviews, certain compilations and examinations of prospective financial information, and for preparing an original or amended tax return or claim for refund. Permitted exceptions include representing a client in an IRS examination or appeal, and fees fixed by courts or public authorities.

HOW THIS IS TESTED

- Is the CPA independent? Look for financial interests and family, employment and business relationships.
- Which threat is this? Match the facts to one of the seven threats.
- Can the CPA perform this service? Check whether it involves management responsibilities.
- Can the CPA disclose this information? Apply the confidentiality rule and its exceptions.

Scenario: Your 35-year-old sister, who is not your dependent, is the CFO of XYZ Company, a prospective audit client. Can you serve on the engagement?

Answer: No. Your sister is a close relative in a key position at the client, which impairs your independence. The firm can still perform the audit if you are not a covered member on the engagement.

Independence Rules of Other Regulators

Several regulators impose rules that can be stricter than the AICPA's.

SEC AND PCAOB (AUDITS OF PUBLIC COMPANIES)

- **Cooling-off period:** a one-year cooling-off period applies before certain members of the audit team can take a financial reporting oversight role, such as CEO, CFO or controller, at the client.
- **Audit committee preapproval:** the audit committee must preapprove audit and permitted nonaudit services.
- **Prohibited nonaudit services**, even if the client accepts responsibility: bookkeeping, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing, management functions, human resources, broker-dealer and investment services, legal services and expert services unrelated to the audit.
- **Partner rotation:** the lead and concurring partners rotate off after five years, followed by a five-year time-out.
- The PCAOB adopts the SEC's independence requirements and adds its own rules, such as those on tax services for persons in financial reporting oversight roles.

GAO GOVERNMENT AUDITING STANDARDS (THE YELLOW BOOK)

- Applies to audits of government entities and organizations that receive government awards.
- Requires the conceptual framework to be applied to evaluate independence.
- Auditors may not perform management responsibilities, and for nonaudit services they must document the client's ability to oversee the service and the safeguards applied.
- **CPE:** 80 hours every two years, including at least 24 hours directly related to government auditing or the government environment, and at least 20 hours in each year.

DEPARTMENT OF LABOR (EMPLOYEE BENEFIT PLANS)

- Applies to audits of employee benefit plans such as 401(k) and pension plans.
- The auditor may not hold a financial interest in the plan or the plan sponsor, or serve as a trustee, officer or employee of the plan or sponsor.

HOW TO REMEMBER

- **SEC and PCAOB:** public companies, with the strictest limits on nonaudit services
- **GAO:** government audits, requiring the conceptual framework and specific CPE
- **DOL:** employee benefit plans, focused on relationships with the plan and its sponsor
- **AICPA:** the baseline that the others build on

Scenario: You audit a public company that asks your firm to design and implement its new accounting system. Can you accept?

Answer: No. SEC rules prohibit financial information systems design and implementation for audit clients.

Professional Skepticism

Professional skepticism is an attitude that includes a questioning mind, alertness to conditions that may indicate misstatement and a critical assessment of evidence. It is not cynicism, and it is not blind acceptance of management's statements.

APPLYING IT

1. **Question management's assertions.** Ask how they know and what supports it.
2. **Watch for contradictory evidence.** If revenue is up 20% but receivables are up 50%, find out why.
3. **Don't settle for weak evidence.** Seek corroboration.
4. **Remember management override.** Management can override even good controls.
5. **Consider other explanations.** Don't accept the first explanation offered.

WHEN EXTRA SKEPTICISM IS NEEDED

- Significant unusual transactions, especially near year-end
- Areas that require significant judgment, such as estimates and valuations

- Complex transactions
- Related party transactions
- Vague or inconsistent explanations from management
- Pressure on management, such as nearing a debt covenant violation

Scenario: The receivables aging shows 90% of balances are current, but cash collections in January are far lower than December sales suggest.

Answer: This contradiction calls for skepticism. Expand confirmations, test the aging more extensively, examine December sales and post-year-end credit memos, and consider channel stuffing, bill-and-hold arrangements and side agreements.

Quality Management

The AICPA's quality management standards replaced the old quality control standards (QC 10) for firms' systems effective December 15, 2025.

SQMS NO. 1: A FIRM'S SYSTEM OF QUALITY MANAGEMENT

A risk-based system with **eight components**:

1. **Governance and leadership:** a culture that supports quality, starting at the top
2. **The firm's risk assessment process:** setting quality objectives, identifying risks to them and designing responses
3. **Relevant ethical requirements:** including independence
4. **Acceptance and continuance** of client relationships and engagements
5. **Engagement performance:** direction, supervision, review and consultation
6. **Resources:** people, technology and intellectual resources
7. **Information and communication**
8. **The monitoring and remediation process**

SQMS NO. 2: ENGAGEMENT QUALITY REVIEWS

Covers the appointment and eligibility of engagement quality reviewers and how the review is performed and documented. The reviewer must be objective and not part of the engagement team, and the review must be completed before the report is released.

SAS NO. 146 (AU-C 220)

Covers quality management at the engagement level. The engagement partner takes overall responsibility for managing and achieving quality on the audit.

Terms of Engagement

PRECONDITIONS FOR AN AUDIT (AU-C 210)

Before accepting an audit, the auditor must determine that:

1. **The financial reporting framework is acceptable**, such as GAAP or IFRS, or a special purpose framework like the cash or tax basis.
2. **Management acknowledges its responsibilities** for:
 - Preparing and fairly presenting the financial statements
 - Designing, implementing and maintaining relevant internal control
 - Giving the auditor access to all relevant information, additional information requested and unrestricted access to people within the entity

If the preconditions aren't met, the auditor should decline the engagement.

THE ENGAGEMENT LETTER

The agreed terms must be documented in an engagement letter or other written agreement, including:

- The objective and scope of the audit
- The auditor's responsibilities
- Management's responsibilities
- The applicable financial reporting framework
- The expected form and content of the reports
- A statement that, because of inherent limitations, some material misstatements may not be detected

Letters often also cover fees, the management representation letter, client assistance and regulator access to workpapers. Consider revising the terms when circumstances change, such as a change in senior management, ownership or the nature of the business.

SCOPE LIMITATIONS IMPOSED BY MANAGEMENT

- **Before acceptance:** if management imposes a limitation that would result in a disclaimer, decline the engagement.
- **After acceptance:** ask management to remove it. If they won't, communicate with those charged with governance and determine whether you can perform alternative procedures. If not, issue a qualified opinion or disclaimer, or withdraw if the effects could be both material and pervasive and withdrawal is possible.

General Audit Principles

UNDERSTANDING THE ENTITY (AU-C 315)

The auditor understands the entity to identify and assess risks of material misstatement, including:

- Industry, regulatory and other external factors

- The nature of the entity: operations, ownership, governance, investments and financing
- The financial reporting framework and accounting policies
- Objectives, strategies and related business risks
- How management measures and reviews financial performance
- The system of internal control, including IT

MATERIALITY (AU-C 320)

Misstatements are material if they could reasonably be expected to influence the economic decisions of users.

- **Materiality for the financial statements as a whole:** set during planning. Common benchmarks are about 5% of pretax income from continuing operations, 0.5% to 1% of revenue or total assets, or 1% to 5% of equity. These are rules of thumb. Professional judgment decides.
- **Performance materiality:** set below overall materiality to reduce the risk that uncorrected and undetected misstatements add up to a material amount. Often 50% to 75% of overall materiality.
- **Clearly trivial threshold:** misstatements below it are not accumulated. Often around 3% to 5% of overall materiality.

Qualitative factors can make small amounts material, for example a misstatement that turns a profit into a loss, affects debt covenant compliance or management compensation, involves fraud or involves related parties.

Revise materiality if you learn information during the audit that would have changed it.

AUDIT DOCUMENTATION (AU-C 230)

Documentation shows the audit was planned and performed in accordance with GAAS and supports the report. It includes the audit strategy and plan, risk assessments and responses, procedures performed, evidence obtained, significant matters and conclusions, and communications with management and those charged with governance.

REQUIREMENT	AICPA (NONISSUERS)	PCAOB (ISSUERS)
Final assembly of the file	Within 60 days after the report release date	Within 45 days after the report release date
Minimum retention	5 years from the report release date	7 years from the report release date

After assembly, documentation may not be deleted. Additions must document when, why and by whom they were made.

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE (AU-C 260)

Those charged with governance include the audit committee, the board of directors or an owner-manager.

The auditor communicates:

- The auditor's responsibilities under GAAS
- An overview of the planned scope and timing
- Significant findings, including qualitative aspects of accounting practices, significant difficulties, disagreements with management, uncorrected misstatements, management's consultations with other accountants and significant

related party matters

Communication may be oral or written, but significant findings must be in writing if the auditor judges oral communication inadequate. Significant deficiencies and material weaknesses in internal control must always be communicated in writing (AU-C 265).

Area II: Assessing Risk and Developing a Planned Response

Planning and Supervision (AU-C 300)

OVERALL AUDIT STRATEGY

The strategy sets the scope, timing and direction of the audit, and guides the detailed audit plan. It considers:

1. Characteristics of the engagement, such as the framework, industry requirements and locations
2. Reporting objectives, deadlines and the timing of communications
3. Significant factors, such as materiality and preliminary high-risk areas
4. Results of preliminary activities, such as independence and the engagement letter
5. Resources needed, including specialists, budget and timeline

AUDIT PLAN

More detailed than the strategy. It describes the nature, timing and extent of risk assessment procedures and further audit procedures.

Planning is continuous. Update the strategy and plan as the audit progresses, and document significant changes and the reasons for them.

SUPERVISION AND REVIEW

- The engagement partner is responsible for the direction, supervision and performance of the engagement.
- The team discusses the susceptibility of the financial statements to material misstatement, including fraud.
- More experienced team members review the work of less experienced members before the report is released.

Question: Which comes first, the overall audit strategy or the audit plan?

Answer: The strategy. It sets the scope, timing and direction, and the more detailed plan is developed from it.

Understanding Internal Control

Obtaining an understanding of the components of internal control is required on every audit.

THE FIVE COSO COMPONENTS

1. Control environment: the tone at the top and the foundation for all other components. Includes integrity and ethical values, commitment to competence, board and audit committee oversight, management's philosophy and operating style, organizational structure and HR policies.

Signs of a weak control environment: high accounting turnover, frequent management override, a weak or absent audit committee, pressure to hit unrealistic targets and compensation heavily tied to short-term results.

Response: assess control risk as high, increase substantive procedures, perform more work at year-end and heighten skepticism.

2. Risk assessment: the entity's process for identifying and responding to business risks, such as new accounting pronouncements, new technology, new product lines, rapid growth, restructuring, foreign operations and economic change.

3. Control activities: the policies and procedures that carry out management's directives.

- Authorization of transactions by an appropriate person
- **Segregation of duties** among authorization, recording and custody of assets. In small companies, active owner review can partly compensate.
- Physical controls, such as locked storage and system passwords
- Independent verification and reconciliations, such as bank reconciliations and subledger-to-ledger reconciliations
- Reviews of performance, such as budget-to-actual analysis

IT controls

- **General controls (ITGCs):** access, program changes, computer operations, and backup and recovery
- **Application controls:** input controls such as edit checks, processing controls such as control totals, and output controls such as report review

Preventive or detective: preventive controls stop errors before they happen. Detective controls find them after they happen.

4. Information and communication: how transactions are initiated, recorded, processed and reported, and how roles and responsibilities are communicated internally and externally.

5. Monitoring activities: ongoing monitoring, such as supervisory review, and separate evaluations, such as internal audit, with deficiencies communicated and corrected.

THE AUDITOR'S PROCESS

1. **Obtain an understanding** of each component through inquiry, observation, inspection and walkthroughs. A walkthrough follows one transaction from initiation to the financial statements.
2. **Document** the understanding with narratives, flowcharts, questionnaires or a combination.
3. **Identify controls** that address risks of material misstatement at the assertion level.
4. **Assess the risks of material misstatement** for each relevant assertion.

DECIDING WHETHER TO TEST CONTROLS

Testing controls is required when the auditor plans to rely on them, or when substantive procedures alone cannot provide sufficient appropriate evidence, as in highly automated environments. Otherwise it is a choice based on efficiency.

The auditor is less likely to test controls when the control environment is poor, controls are weak or missing, or substantive procedures alone are more efficient.

TESTS OF CONTROLS

Procedures include inquiry, observation, inspection of evidence that the control was performed, and reperformance.

Inquiry alone is never sufficient.

Sample sizes depend on risk and how often the control operates. Frequent manual controls often call for roughly 25 to 60 items, while controls performed quarterly or annually need far fewer.

- **Controls effective:** the auditor can rely on them and reduce substantive procedures.
- **Controls not effective:** the auditor can't rely on them and must expand substantive procedures or test compensating controls.

CONTROL DEFICIENCIES (AU-C 265)

Severity depends on the **likelihood** and **magnitude** of a potential misstatement.

1. **Deficiency:** a control is missing or not working as designed.
2. **Significant deficiency:** less severe than a material weakness, yet important enough to merit the attention of those charged with governance.
3. **Material weakness:** a reasonable possibility that a material misstatement will not be prevented, or detected and corrected, on a timely basis.

Indicators of a material weakness include fraud by senior management (whether or not material), a restatement to correct a material misstatement, a material misstatement found by the auditor that internal control would not have caught, and ineffective oversight by those charged with governance.

Communication: significant deficiencies and material weaknesses must be communicated in writing to management and those charged with governance, preferably by the report release date and no later than 60 days after it.

Important: in a financial statement audit, a material weakness does not by itself change the opinion. The opinion is on the financial statements, not on internal control, except in an integrated audit.

Scenario: One employee enters vendor invoices, approves them for payment and can add new vendors, and no one reviews changes to the vendor file. Purchases are \$20 million a year, and materiality is \$100,000.

Answer: This is likely a material weakness. The likelihood is high, because the employee could create a fake vendor without detection, and the potential magnitude far exceeds materiality. It must be communicated in writing.

Assessing the Risks of Material Misstatement (AU-C 315)

The risk of material misstatement (RMM) combines **inherent risk** and **control risk**, and is assessed at the financial statement level and at the assertion level.

INHERENT RISK

The susceptibility of an assertion to material misstatement before considering controls. **Inherent risk factors** include complexity, subjectivity, change, uncertainty, and susceptibility to misstatement from management bias or fraud. Revenue, inventory and estimates are often higher risk.

CONTROL RISK

The risk that a misstatement won't be prevented, or detected and corrected, by internal control. If the auditor does not plan to test the operating effectiveness of controls, control risk is assessed at the maximum.

INHERENT RISK	CONTROL RISK	RMM	RESPONSE
High	High	High	Most extensive substantive procedures
High	Low	Moderate	Moderate substantive procedures
Low	High	Moderate	Moderate substantive procedures
Low	Low	Low	Least extensive substantive procedures

Detection risk is what the auditor controls. The higher the RMM, the lower the acceptable detection risk, and the more persuasive the evidence needed.

SIGNIFICANT RISKS

Risks close to the upper end of the spectrum of inherent risk. They often involve fraud, complex or unusual transactions, related parties or significant judgment. For each significant risk, the auditor must:

- Understand the related controls
- Perform substantive procedures specifically responsive to the risk
- Test controls in the current year if planning to rely on them

RISK ASSESSMENT PROCEDURES

1. Inquiries of management and others
2. Analytical procedures
3. Observation and inspection, such as touring facilities and reading minutes and contracts

Question: What does it mean when an auditor assesses control risk at the maximum?

Answer: The auditor is not relying on controls, either because they are ineffective or because the auditor chose not to test them. Substantive procedures must be more extensive.

Fraud (AU-C 240)

THE FRAUD TRIANGLE

1. **Incentive or pressure:** financial stress, unrealistic targets and compensation tied to results
2. **Opportunity:** weak controls, the ability to override and poor oversight
3. **Attitude or rationalization:** "Everyone does it," "I'll pay it back" or "The company owes me"

TYPES OF FRAUD

1. **Fraudulent financial reporting:** intentional misstatements or omissions meant to deceive users, usually by management. Examples include fictitious revenue, understated expenses and liabilities, and overstated assets.
2. **Misappropriation of assets:** theft by employees or management, such as embezzlement, inventory theft, skimming and fraudulent disbursements.

THE AUDITOR'S RESPONSIBILITY

The auditor must obtain reasonable assurance that the financial statements are free of material misstatement, whether due to fraud or error. That includes maintaining skepticism, holding a team discussion, making inquiries, assessing fraud risks and responding to them.

The auditor is not responsible for detecting immaterial fraud or for determining legally whether fraud occurred. Because of collusion and forgery, even a properly performed audit may not detect a material fraud.

REQUIRED PROCEDURES

1. **Engagement team discussion** about how and where the statements could be misstated due to fraud.
2. **Inquiries** of management, those charged with governance, internal audit and others about fraud risks and known or suspected fraud.
3. **Analytical procedures**, especially on revenue, looking for unusual relationships.
4. **Identifying and assessing** fraud risks.
5. **Responding** to assessed risks:
 - *Overall:* assign experienced staff, increase skepticism and supervision, and add unpredictability, such as surprise counts or changed timing.
 - *Specific:* change the nature, timing and extent of procedures. For revenue, that might mean more confirmations, contract reviews and cutoff tests.

PRESUMED FRAUD RISKS

1. **Improper revenue recognition** is presumed to be a fraud risk. The presumption can be rebutted only when documented, for example a single simple revenue stream.
2. **Management override of controls** is present in every audit and cannot be rebutted. Required responses:
 - Test journal entries and other adjustments, especially at period-end, with unusual accounts, made by senior management or lacking explanation
 - Review accounting estimates for bias

- Evaluate the business rationale for significant unusual transactions

IF FRAUD IS IDENTIFIED OR SUSPECTED

1. Evaluate the implications, including whether there could be more and who is involved.
2. Communicate to the appropriate level of management, at least one level above those involved. Fraud involving senior management, or any fraud causing material misstatement, goes to those charged with governance.
3. Reevaluate the risk assessment and the reliability of management's representations.
4. Consider whether a duty exists to report outside the entity. Confidentiality usually prevents it, with exceptions for legal requirements, subpoenas, successor auditor inquiries with permission and government audit requirements.
5. Consider withdrawing if management doesn't act appropriately.

Scenario: Several large journal entries labeled "year-end accrual adjustments" were posted by the CFO on December 31 and increased income.

Answer: These are red flags for management override. Examine the support, question the business rationale, determine whether the entries comply with GAAP, look for similar entries and expand journal entry testing. If fraud is suspected, communicate with those charged with governance.

Going Concern (AU-C 570)

Under GAAP (ASC 205-40), management evaluates whether there is substantial doubt about the entity's ability to continue as a going concern **within one year after the date the financial statements are issued or available to be issued**. The auditor evaluates management's assessment.

Substantial doubt exists when conditions and events indicate it is probable the entity will be unable to meet its obligations as they come due within that period.

INDICATORS

- **Financial:** recurring losses, negative cash flows, working capital deficits, loan defaults or covenant violations, dividend arrearages, a need to restructure debt or sell substantial assets
- **Operating:** loss of key people, a major customer or supplier, or a license or franchise, and labor difficulties
- **Other:** legal proceedings and noncompliance with regulations

MANAGEMENT'S PLANS

Plans may include selling assets, borrowing or restructuring debt, cutting expenses or raising equity. The auditor evaluates whether the plans are likely to be implemented and to mitigate the conditions.

REPORTING

SITUATION	EFFECT ON THE REPORT
No substantial doubt	Unmodified opinion, no going concern section
Substantial doubt alleviated by management's plans, adequately disclosed	Unmodified opinion. No going concern section is required, although the auditor may add an emphasis-of-matter paragraph
Substantial doubt remains and is adequately disclosed	Unmodified opinion with a separate section titled "Substantial Doubt About the Entity's Ability to Continue as a Going Concern"
Required disclosure missing or inadequate	Qualified or adverse opinion (a departure from GAAP)
Going concern basis of accounting is inappropriate	Adverse opinion

Question: A company has recurring losses and negative cash flows. Management plans a stock offering that the auditor concludes is probable and will alleviate the doubt. How does the auditor report?

Answer: An unmodified opinion. Because management's plans alleviate the substantial doubt, no going concern section is required. GAAP still requires disclosure of the conditions and management's plans, and the auditor may emphasize the matter.

Related Parties (AU-C 550)

Related parties under ASC 850 include affiliates, principal owners and their immediate families, management and their immediate families, equity-method investees, employee benefit trusts managed by management, and any party that can significantly influence the other.

WHY AUDITORS CARE

Related party transactions may not be at arm's length, may lack business substance, may be used to manipulate the financial statements and may go undisclosed. Examples include sales at inflated prices to boost revenue, below-market loans to officers and "parking" inventory with a related party.

THE AUDITOR'S RESPONSIBILITIES

1. Understand related party relationships and transactions through inquiry, minutes, contracts, shareholder records and conflict-of-interest statements.
2. Treat significant related party transactions outside the normal course of business as significant risks.
3. Respond by examining agreements, confirming terms, evaluating business rationale and testing for side agreements.
4. Evaluate accounting and disclosure: the nature of the relationship, a description of the transactions, the dollar amounts and amounts due. Control relationships must be disclosed even without transactions.
5. Obtain written representations about the completeness of related party information.

Scenario: The company bought land from the CEO's brother for \$500,000. An appraisal values it at \$300,000, and the transaction isn't disclosed.

Answer: The brother is a related party, the price suggests the transaction wasn't at arm's length, and the required disclosure is missing. Evaluate whether the land is overstated and whether the substance is a payment to a related party, consider whether this indicates fraud or other undisclosed transactions, and communicate with those charged with governance. If management won't correct the accounting and disclosure, modify the opinion.

Area III: Performing Further Procedures and Obtaining Evidence

Audit Evidence (AU-C 500)

Evidence must be **sufficient** (enough of it) and **appropriate** (relevant and reliable).

- **Sufficiency** rises with the assessed risk and falls as quality rises.
- **Relevance** depends on the assertion. A bank confirmation supports the existence of cash, not the valuation of inventory.

Evidence is generally more reliable when it is:

- From independent sources outside the entity
- Obtained directly by the auditor
- Generated under effective controls
- In documentary form rather than oral
- An original rather than a copy

Rough reliability ranking, most to least:

1. The auditor's direct inspection, observation or recalculation
2. External confirmations sent directly to the auditor
3. External documents held by the client, such as bank statements
4. Internal documents that circulate outside the entity, such as sales invoices
5. Internal documents that never leave the entity
6. Oral representations

Assertions

Under the current AU-C 315, the assertions are:

Classes of transactions and events

- **Occurrence:** recorded transactions happened and pertain to the entity
- **Completeness:** all transactions that should be recorded are recorded
- **Accuracy:** amounts are recorded appropriately
- **Cutoff:** transactions are recorded in the correct period
- **Classification:** transactions are recorded in the proper accounts
- **Presentation:** transactions are appropriately aggregated, described and disclosed

Account balances

- **Existence:** assets, liabilities and equity exist
- **Rights and obligations:** the entity holds or controls the rights to assets, and liabilities are its obligations
- **Completeness:** everything that should be recorded is recorded
- **Accuracy, valuation and allocation:** balances are recorded at appropriate amounts
- **Classification:** balances are recorded in the proper accounts
- **Presentation:** balances are appropriately aggregated, described and disclosed

Types of Audit Procedures

1. **Inspection of records or documents**, such as vendor invoices
2. **Inspection of tangible assets**, such as physically examining equipment
3. **Observation** of a process, such as the client's inventory count
4. **Inquiry** of knowledgeable people. Never sufficient on its own.
5. **External confirmation**, a direct written response from a third party
6. **Recalculation** of mathematical accuracy
7. **Reperformance** of a procedure or control
8. **Analytical procedures**, evaluating plausible relationships among data

SUBSTANTIVE PROCEDURES

- **Tests of details** examine specific transactions and balances, such as confirmations and vouching.
- **Substantive analytical procedures** compare recorded amounts to the auditor's expectations.

Substantive procedures are required for each material class of transactions, account balance and disclosure, even when controls are tested.

Timing: procedures at an interim date require additional work to cover the period to year-end.

Extent increases with higher risk and lower materiality, and decreases when controls are tested and found effective.

Procedures by Account

CASH

Key assertions: existence, completeness, rights and obligations.

- **Bank confirmations:** a common practice that confirms balances, loans and other arrangements, sent and received directly by the auditor
- **Test the bank reconciliation:** agree balances to the confirmation and the ledger, and trace outstanding checks and deposits in transit to the subsequent bank statement
- **Cash counts** when cash on hand is significant, counted at all locations at the same time
- **Cutoff:** test receipts and disbursements near year-end
- **Kiting:** prepare an interbank transfer schedule to make sure each transfer is recorded as a disbursement and a receipt in the same period
- **Restrictions:** identify restricted cash and confirm it is properly classified and disclosed

ACCOUNTS RECEIVABLE

Key assertions: existence and valuation.

Confirmations are presumed for material receivables unless they are ineffective or the risk is low and other procedures address it.

- **Positive confirmations** ask the customer to respond either way. Use them for large balances, suspected errors and disputes. A blank form, where the customer fills in the amount, is more reliable but gets fewer responses.
- **Negative confirmations** ask for a response only if the customer disagrees. Use them only as the sole procedure when RMM is low, there are many small balances, few exceptions are expected and customers are likely to read them.
- The **auditor controls** the process: selecting, sending and receiving confirmations directly.
- **Nonresponses:** send a second request, then perform alternative procedures such as examining subsequent cash receipts and shipping documents.
- **Exceptions:** investigate timing differences, goods in transit, disputes and errors.

Other procedures include analytical procedures such as days sales outstanding and turnover, testing the allowance for credit losses through the aging and subsequent collections, checking for pledged or factored receivables, and testing sales cutoff against shipping terms.

INVENTORY

Key assertions: existence, completeness, valuation, rights and obligations.

Observe the physical count when inventory is material, unless it is impracticable.

- *Before:* review count instructions and tour the facilities.
- *During:* observe counters, make test counts both from the floor to the records and from the records to the floor, record the last receiving and shipping documents for cutoff, and watch for obsolete items, empty containers and

goods the company doesn't own.

- *After:* trace test counts to the final listing and account for all count tags.

If inventory is held by a third party, confirm it and consider observing it. If the auditor can't attend on the count date, observe a later count and roll the results back. If the client prevents observation and no alternative procedures work, that is a scope limitation.

Valuation: test cost calculations under FIFO, LIFO or average cost, trace costs to invoices, test overhead allocation and apply lower of cost and net realizable value, or market for LIFO and retail. Look for slow-moving and obsolete items through aging reports, observation and subsequent sales.

Rights: exclude goods held on consignment from others, include goods consigned out and look for liens.

Cutoff: goods received before year-end belong in inventory and payables. Goods shipped before year-end, under FOB shipping point terms, belong in sales and not in inventory.

INVESTMENTS

Key assertions: existence, valuation, rights and classification.

- Inspect securities on hand, or confirm with the custodian or broker.
- Test valuation with quoted prices for traded securities and evaluate models and assumptions for those without quotes.
- For equity-method investments, obtain the investee's financial statements and recalculate the investor's share.
- Evaluate management's intent and ability for debt security classifications.
- Recalculate interest and dividend income.

PROPERTY, PLANT AND EQUIPMENT

Key assertions: existence, completeness and valuation.

- **Additions:** vouch to invoices and contracts, confirm all costs of getting assets ready for use were capitalized and inspect major additions.
- **Disposals:** confirm cost and accumulated depreciation were removed and the gain or loss recorded.
- **Depreciation:** recalculate, and evaluate useful lives and methods.
- **Rights:** review deeds, titles and lien searches.
- **Impairment:** ask about indicators and test management's analysis.

ACCOUNTS PAYABLE

Key assertion: **completeness**. The main risk is understatement.

Search for unrecorded liabilities by examining payments made after year-end, unmatched receiving reports and invoices, vendor statements and purchase commitments.

Confirmations aren't usually sent, but may be when controls are weak or for vendors with small or zero recorded balances that have significant activity. Also test cutoff and use analytical procedures such as days payable outstanding.

LONG-TERM DEBT

Key assertions: completeness, valuation and presentation.

- Confirm loans with lenders, including balances, rates, terms, collateral and covenants.
- Examine agreements for new debt and trace proceeds.
- Recalculate interest and the amortization of premiums, discounts and issuance costs.
- Test covenant compliance and the classification and disclosure of any violations.

STOCKHOLDERS' EQUITY

- Review board authorizations for issuances, repurchases and dividends.
- Confirm shares outstanding with the transfer agent and registrar.
- Trace proceeds and payments, and check par value and additional paid-in capital.
- Roll forward retained earnings: beginning balance plus net income, less dividends, plus or minus prior period adjustments.

REVENUE

Key assertions: **occurrence**, which carries the greatest fraud risk, cutoff and accuracy.

- Analytical procedures on gross margin, revenue against receivables and monthly trends
- Vouch recorded sales to customer orders, shipping documents and invoices, and test pricing
- Cutoff testing based on shipping and contract terms
- Look for revenue fraud through post-year-end returns and credit memos, unusual contract terms, bill-and-hold arrangements and side agreements

EXPENSES AND ACCRUALS

- Analytical procedures against prior year and budget
- Vouch significant expenses to support
- Test accruals such as payroll, vacation and bonuses for completeness
- Check classification between cost of sales and operating expenses

Audit Sampling (AU-C 530)

Sampling applies procedures to less than 100% of a population to draw conclusions about the whole.

- **Statistical sampling** uses random selection and probability theory, so sampling risk can be measured.
- **Nonstatistical sampling** relies on judgment, so sampling risk can't be measured. Both are acceptable if properly designed.

SAMPLING FOR TESTS OF CONTROLS

- **Risk of assessing control risk too low** (overreliance): the more serious risk, because it affects effectiveness.
- **Risk of assessing control risk too high** (underreliance): affects efficiency.

Sample size **increases** with a lower tolerable deviation rate, a higher expected deviation rate and a lower acceptable risk of overreliance.

Selection methods include random, systematic (every nth item) and haphazard selection.

Evaluation: if the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate, don't rely on the control. Investigate the nature and cause of every deviation, including whether it was intentional.

SAMPLING FOR SUBSTANTIVE TESTS

- **Risk of incorrect acceptance:** accepting a materially misstated balance. The more serious risk.
- **Risk of incorrect rejection:** rejecting a fairly stated balance. Affects efficiency.

Sample size **increases** with lower tolerable misstatement, higher expected misstatement, lower acceptable risk and greater population variability. Stratification reduces variability. Probability-proportional-to-size (PPS) sampling makes larger items more likely to be selected.

Evaluation: project the misstatements to the population and compare the projection, plus an allowance for sampling risk, to tolerable misstatement. Consider qualitative aspects such as fraud.

Nonsampling risk is the risk of a wrong conclusion for reasons unrelated to sampling, such as using the wrong procedure or misreading evidence. It is reduced through planning, supervision and review.

Accounting Estimates (AU-C 540)

Estimates include credit loss allowances, inventory reserves, warranty obligations, pension obligations, useful lives, fair values and contingencies. They involve judgment, uncertainty and the risk of management bias.

The auditor's procedures

1. Understand how management makes the estimate: the methods, assumptions, data and controls.
2. Use one or more approaches:
 - Test how management made the estimate, including its data, assumptions and calculations
 - Develop an independent point estimate or range and compare it
 - Use events occurring up to the report date, such as a customer's bankruptcy after year-end that confirms an uncollectible receivable
3. Look for indicators of management bias, including patterns over time.
4. Evaluate whether disclosures about estimation uncertainty are adequate.

FAIR VALUE

GAAP's fair value hierarchy:

- **Level 1:** quoted prices in active markets for identical items
- **Level 2:** other observable inputs
- **Level 3:** unobservable inputs. These require the most audit work.

USING A SPECIALIST (AU-C 620)

Specialists help with complex valuations, actuarial calculations and environmental liabilities. The auditor evaluates the specialist's competence, capabilities and objectivity, understands their work and evaluates their findings. The auditor's report does not refer to the specialist unless the opinion is modified and the reference helps explain the modification.

Subsequent Events (AU-C 560)

Events between the balance sheet date and the date of the auditor's report.

- **Recognized (adjusting) events:** give more evidence about conditions that **existed at the balance sheet date**. Adjust the statements. Examples: a customer's bankruptcy caused by deterioration that existed at year-end, or settlement of a lawsuit over events before year-end.
- **Nonrecognized (nonadjusting) events:** conditions that **arose after the balance sheet date**. Don't adjust, but disclose if needed to keep the statements from being misleading. Examples: a fire or flood after year-end, a new loan, a stock issuance or a major acquisition.

Procedures up to the report date: inquire of management, read minutes and the latest interim statements, and review subsequent transactions.

After the report date: the auditor has no obligation to perform procedures. If the auditor learns of a fact that might have changed the report, the auditor discusses it with management and determines whether the statements need revision. If management won't take necessary steps for statements already issued, the auditor notifies those charged with governance and acts to prevent reliance on the report.

Litigation, Claims and Assessments (AU-C 501)

Procedures

1. Inquire of management about its policies for identifying litigation and the status of matters.
2. Read minutes and correspondence with lawyers, and examine legal expense invoices.
3. When the auditor identifies a risk of material misstatement related to litigation, send a **letter of inquiry** to the entity's external legal counsel. The letter is prepared by management and sent by the auditor, and the lawyer replies directly to the auditor.

The lawyer is asked to evaluate pending and threatened litigation and to comment on management's description of unasserted claims. Lawyers may limit responses on unasserted claims.

Under ASC 450:

- **Probable** (likely to occur): accrue if reasonably estimable, and disclose
- **Reasonably possible** (more than remote, less than likely): disclose only
- **Remote** (slight chance): generally no disclosure

A lawyer's refusal to respond is a scope limitation that can lead to a qualified opinion or disclaimer.

Question: The lawyer's letter describes a lawsuit whose unfavorable outcome is reasonably possible, with a potential loss of \$2 million. What's required?

Answer: Disclosure, but no accrual. Disclose the nature of the contingency and the estimated loss or range, or state that an estimate can't be made.

Area IV: Forming Conclusions and Reporting

The Auditor's Report (AU-C 700)

The unmodified report for a nonissuer is titled "**Independent Auditor's Report**" and contains:

1. **Opinion** (first): the financial statements present fairly, in all material respects, in accordance with the applicable framework.
2. **Basis for opinion:** the audit followed GAAS, the auditor is independent and met ethical responsibilities, and the evidence is sufficient and appropriate.
3. **Responsibilities of management** for the statements and internal control, and for evaluating going concern.
4. **Auditor's responsibilities:** reasonable assurance, professional judgment and skepticism, and the procedures required by GAAS.
5. Signature, city and state, and **date**, which is no earlier than the date the auditor obtained sufficient appropriate evidence.

Key audit matters may be communicated in a nonissuer audit if the auditor is engaged to do so.

Modified Opinions (AU-C 705)

NATURE OF THE PROBLEM	NOT PERVASIVE	PERVASIVE
Material misstatement (GAAP departure)	Qualified ("except for")	Adverse
Unable to obtain sufficient appropriate evidence (scope limitation)	Qualified ("except for ... possible effects")	Disclaimer

- A **qualified opinion** adds a "Basis for Qualified Opinion" section.
- An **adverse opinion** states that the statements do not present fairly. Example: failing to consolidate a material subsidiary.
- A **disclaimer** states the auditor does not express an opinion. Example: the client won't allow confirmation of receivables or observation of inventory, and both are material.

Pervasive effects are not confined to specific elements, or represent a substantial part of the statements, or involve disclosures fundamental to users' understanding.

Emphasis-of-Matter and Other-Matter Paragraphs (AU-C 706)

Emphasis-of-matter paragraph: draws attention to something properly presented or disclosed in the statements that is fundamental to users' understanding. It does not modify the opinion.

Required by GAAS, for example: a justified change in accounting principle and financial statements prepared under a special purpose framework.

Optional, for example: a major catastrophe, significant related party transactions or a significant subsequent event.

Substantial doubt about going concern gets its own separate section, not an emphasis-of-matter paragraph.

Other-matter paragraph: addresses something **not** presented in the statements that is relevant to users' understanding of the audit or the report, such as a predecessor auditor's report on the prior period.

Comparative Financial Statements

- Both years audited by you: the opinion covers both years.
- Prior year audited by a **predecessor** whose report isn't reissued: an other-matter paragraph states that another auditor audited the prior year, the date of that report and the type of opinion, with reasons if it was modified.
- Prior year **not audited**: state that in an other-matter paragraph.
- A modification affecting only one year: modify the opinion only for that year.

Group Audits (AU-C 600)

The group auditor (the engagement team for the group) may use the work of component auditors.

- **No reference:** the group auditor takes responsibility for the component auditor's work and must be sufficiently involved in it. This is the most common approach.
- **Making reference:** the report refers to the audit of a component by another auditor and indicates the portion audited. Strict conditions apply.

SAS 149, effective for periods ending on or after December 15, 2026, revises AU-C 600 with a risk-based approach and introduces the term "referred-to auditor" for a component auditor whose work is referenced.

Dating the Report

The report is dated no earlier than when the auditor obtains sufficient appropriate evidence, including evidence that the complete statements were prepared and management took responsibility for them.

If a subsequent event is disclosed after the report date but before issuance, the auditor can either redate the report or **dual date** it: "...except for Note X, as to which the date is..."

Engagements Under SSARS

REVIEW ENGAGEMENTS (AR-C 90)

- Provides **limited assurance**, expressed as a conclusion that the accountant is not aware of any material modifications needed.
- Procedures are primarily **inquiry and analytical procedures**. No tests of controls, confirmations or observation are required.
- **Independence is required**. If not independent, the accountant can't perform a review.
- The report is titled "Independent Accountant's Review Report."
- Known departures from the framework are described in a separate paragraph, and the conclusion is modified.

COMPILATION ENGAGEMENTS (AR-C 80)

- **No assurance**. The accountant assists management in presenting financial information in the form of financial statements.
- The accountant must understand the framework and the industry and read the statements for obvious misstatements. Inquiry and analytical procedures are not required.
- **Independence is not required**, but a lack of independence must be disclosed in the report. The accountant may disclose the reasons, and if so must disclose all of them.
- No title is required for the compilation report.
- If management omits substantially all disclosures, the report must say so.

PREPARATION ENGAGEMENTS (AR-C 70)

The accountant prepares financial statements without issuing a report. Each page must state that no assurance is provided.

Attestation Engagements

EXAMINATIONS (AT-C 205)

Provide **reasonable assurance** and an opinion on a subject matter or assertion, such as internal control, compliance or prospective financial information. Independence is required.

AGREED-UPON PROCEDURES (AT-C 215)

The practitioner performs specific procedures that the engaging party agrees are appropriate and reports **findings** without an opinion or conclusion. Independence is required. Under SSAE 19, the report may be general use, although the practitioner may restrict it.

PROSPECTIVE FINANCIAL INFORMATION (AT-C 305)

- **Forecast**: expected results under expected conditions. Suitable for general use.
- **Projection**: results under hypothetical assumptions. Limited to parties negotiating directly with the entity.

An examination provides an opinion on whether the presentation follows guidelines and the assumptions provide a reasonable basis. Reports state that actual results may differ.

Written Representations (AU-C 580)

Required on every audit, dated as of the date of the auditor's report and signed by those responsible, usually the CEO and CFO. They cover management's responsibilities, the completeness of information provided, fraud, laws and regulations, related parties, subsequent events, uncorrected misstatements and specific matters.

If management refuses to provide required representations, the auditor generally **disclaims** an opinion or withdraws. If representations contradict other evidence, the auditor investigates and reconsiders their reliability.

Quick Reference

Assurance and Independence

SERVICE	ASSURANCE	OUTPUT	INDEPENDENCE REQUIRED?
Audit	Reasonable	Opinion	Yes
Examination	Reasonable	Opinion	Yes
Review	Limited	Conclusion	Yes
Agreed-upon procedures	None	Findings	Yes
Compilation	None	Report	No, but disclose
Preparation	None	No report	No

Exam Tips

1. Know the assertions and which procedures test them.
2. Independence is required for audits, examinations, reviews and agreed-upon procedures.
3. "Pervasive" decides between qualified and adverse, or qualified and disclaimer.
4. Know the two presumed fraud risks, the fraud triangle and the required procedures.
5. Understanding internal control is always required. Testing it is required only when relying on it or when substantive procedures alone aren't enough.
6. Substantive procedures are required for every material area, even when controls are effective.
7. Receivable confirmations are presumed. Payables are rarely confirmed because the risk is understatement.
8. Subsequent events: conditions that existed at year-end are adjusted, conditions arising after are disclosed.

9. Going concern doubt that isn't alleviated gets a separate section, with an unmodified opinion when disclosure is adequate.
10. More risk or lower materiality means more evidence.

Next Steps

1. Review this guide one area at a time.
2. Make flashcards for key terms and lists.
3. Practice multiple-choice questions and task-based simulations.
4. Revisit weak areas.
5. Teach the concepts to your study group.

Read every question carefully. The exam tests your ability to tell similar concepts apart.