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Small business audit manual, Volume 1

George Marthinuss

Anita M. Lyons

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Small Business Audit Manual

VOLUME 1

**Small Business
Audit Manual**

AICPA

INTEGRATED

PRACTICE

SYSTEM

**INTEGRATED
PRACTICE
SYSTEM**

VOLUME 1

AICPA

VOLUME 1

***Small Business
Audit Manual***

Authors:
George Marthinuss, CPA
Larry L. Perry, CPA

AICPA

INTEGRATED

PRACTICE

SYSTEM

AICPA

V O L U M E 1

Small Business Audit Manual

OCT 19 1995

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Authors:
George Marthinuss, CPA
Larry L. Perry, CPA

Editor:
Anita M. Lyons, CPA

A I C P A

I N T E G R A T E D

P R A C T I C E

S Y S T E M

This manual has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board and has no official or authoritative status.

The manual is issued as a nonauthoritative kit of practice aids and is not intended as a substitute for professional judgment or for authoritative technical literature.

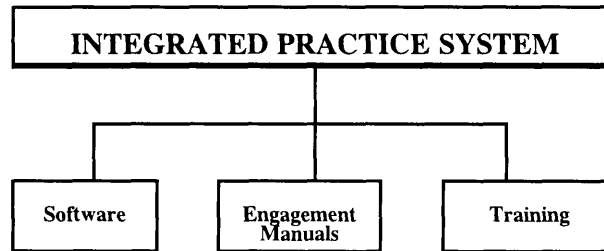
The documentation in this manual is not a substitute for development and implementation by a firm of a system of quality control that is appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

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The AICPA Integrated Practice System: For CPAs Concerned About Quality and Profitability



The Integrated Practice System gives practitioners the tools they need to conduct high-quality and cost-effective engagements. How? By enabling CPAs to anticipate engagement problems and by putting the solutions to these problems — integrated engagement manuals, software products, and training resources — within their grasp.

ONE SYSTEM, ONE SOLUTION

This innovative system is the *first* integrated system that is specifically designed to enhance the quality of your practice. It offers guidance on the day-to-day management of client engagements and provides practical discussions on the applicability of authoritative literature. Each element of the system — manuals, software, and training — was developed by CPAs who recognized the need to provide a comprehensive, hands-on approach to engagement planning and performance. Working alone or as a unified system, Integrated Practice System products provide the solutions needed for a firm to achieve top-quality performance and bottom-line profitability.

INTEGRATED PRACTICE SYSTEM — IN A CLASS BY ITSELF

Significant advantages distinguish these tools from other commercially available products. The Integrated Practice System tools —

- **Represent an integrated, synergistic system** that is state-of-the-art.
- **Include access to technical support hotlines** that put you in touch with professionals who can answer your technical questions. Just call the following numbers:

Engagement Manuals 800-TO-AICPA (800-862-4272)

Software Products 800-226-5800

Training 201-938-3061

- **Receive ongoing field-testing and evaluation** from a task force of the AICPA's Private Companies Practice Section (PCPS) — CPAs who confront similar challenges in their practices and who represent the interests of local and regional firms.
- **Include a 60-day "no-questions-asked" return guarantee** that allows you the time to try the Integrated Practice System products and find out for yourself how your firm and staff can benefit from them.

ENGAGEMENT MANUALS: THE SMART KID ON THE BLOCK

Finally, there is a reliable, step-by-step approach for managing and performing your engagements. The Engagement Manuals point you in the right direction with the time-saving tools you need to conduct high-quality engagements with the greatest efficiency. Right from the start, the Engagement Manuals show you a direct route to protecting your bottom line. You can minimize on-site field work and put an end to "over-auditing" because our exclusive "ABC System" helps you evaluate risk in the critical planning stage. You'll find important guidelines to use in evaluating your client, so that you can adjust the level of testing to the internal controls employed by the client.

The Engagement Manuals feature a practical, "how-to" approach that enables you and your staff to cut through the clutter and focus on what's important. By eliminating time-consuming guesswork, they chart the course to the most cost-effective, efficient way of proceeding with your engagement. Plus, the manuals include ready-to-use forms, programs, checklists, and questionnaires — even sample correspondence to speed your work.

Each Engagement Manual includes —

- Guidance based on the most recent relevant authoritative and non-authoritative literature;
- Integrated work programs and checklists;
- Model letters ready for your use;
- Time-saving worksheets that capture important information and also help users identify opportunities for other services that can be provided to existing clients, such as consulting and tax services and the preparation of prospective financial information.
- Diskettes, in WordPerfect format, that include all the sample letters and accountant's/auditor's reports included in the manual.

What's more, the Engagement Manuals ease the process of quality review by helping you develop the documentation you need.

The Engagement Manuals can be easily used as stand-alone practice aids. Or, you can use them in conjunction with the full complement of software products — including the AICPA's very successful Accountant's Trial Balance (ATB) and Audit Program Generator (APG). It's the flexibility you need for a cost-efficient, high-quality engagement.

The AICPA recognizes your need to be up-to-date on issues that affect your clients — that's why subscribers automatically receive annual updates for the engagement manuals. Our goal, pure and simple: to provide the answers to your questions even before you ask them.

Because the AICPA has an ongoing commitment to developing the practice aids you need to serve your clients, it will continue to release new industry-specific manuals. These will contain the same kind of practical tools and how-to guidance that are the hallmarks of the Engagement Manuals.

Comprehensive Engagement Manual

The *Comprehensive Engagement Manual* can help practitioners manage most engagements. Designed to be the accountant's companion to audit, review, and compilation engagements, this manual includes checklists, forms, flowcharts, questionnaires, tables, and all the documentation necessary for any size client.

This four-volume set covers engagement performance, documentation and reporting, and helps you make key decisions, including —

- Assessing risk and establishing materiality limits;
- Selecting the most cost-beneficial audit approach;
- Designing the most economical auditing procedures; and
- Making sampling decisions that maximize efficiency.

The *Comprehensive Engagement Manual* features the unique and highly-popular "ABC System" that enables practitioners to identify the most cost-beneficial mix of tests of controls, substantive tests of balances, and analytical procedures for specific engagements. This manual is ideal for firms that want a system they can apply to the full spectrum of audit engagements — whether they plan to perform tests of controls or a totally substantive audit.

Small Business Audit Manual

The two-volume *Small Business Audit Manual*, an alternative to the *Comprehensive Engagement Manual*, walks you through each step of the audit of a small business client. Designed for firms that use a substantive testing approach on all of their audits, the *Small Business Audit Manual* helps you to:

- Plan a cost-effective and time-efficient engagement;
- Verify all financial statement assertions using substantive tests;
- Understand a client's internal control structure;
- Better understand how to apply authoritative standards to small business audits;
- Evaluate a small business' computer needs.

The *Small Business Audit Manual* also puts at your fingertips sample audit programs, questionnaires, model letters, time sheets, workpapers, and audit reports for a small business audit engagement — organized in the sequence they will be used. If your firm's audits rely totally on substantive testing, this is the manual for you.

Bank and Savings Institutions Audit Manual

The three-volume *Bank and Savings Institutions Audit Manual* can help you cope with the high risk generally associated with bank audits and the complexity of bank operations. It is designed to enable you to perform high-quality engagements with maximum time savings. Based on the unique "ABC System," this manual allows you to design the most efficient and cost-effective mix of tests of controls and substantive tests of balances, and analytical procedures. It does so by including:

- A framework to help practitioners design the most cost-effective audit strategy;
- Worksheets and forms to help auditors understand a bank's internal control structure and assess risk during engagement planning;
- Programs for interim work;
- Sampling documentation and discussions of professional standards that affect the sampling decision;
- Worksheets for various analytical procedures that can help to identify errors and irregularities;

Construction Contractors Audit Manual

You'll find this two-volume manual your most valuable practice aid when working on engagements for construction contractors. It contains:

- Two audit approaches—the "System's Walk-through Approach" for substantive audits and the "ABC System" — to help you design the most efficient and effective audit strategy for each engagement;
- Practical, how-to guidance for completing construction contractor audits;
- A chapter dedicated to the surety industry to help you understand what the surety wants and needs;
- All the necessary audit programs, forms, checklists, sample correspondence, and working papers to comply with today's quality control standards;
- A supplemental tax preparation checklist specific for construction contractors;
- The AICPA Audit and Accounting Guide, *Construction Contractors*, which contains discussions on the applicability of specific professional standards to engagements for construction contractors.

Compilation and Review Manual

This two-volume set gives you a step-by-step system to help you conduct high quality compilation and review engagements — profitably and in compliance with all current applicable professional standards. It contains:

- Programs, checklists, and sample correspondence for performing compilation and review engagements;
- Reporting guidance for OCBOA and personal financial statements;
- Guidance on performing and reporting on prospective financial information.

Credit Union Audit Manual

The two-volume set outlines the most efficient way to approach audits of credit unions and contains guidance on conducting them in compliance with current professional standards. This manual uses the "ABC System" and a newly designed audit strategy for small credit unions, which allows you to choose the best mix of tests of controls and substantive tests of balances, and analytical procedures for each engagement. This manual contains:

- Audit programs, forms, checklists, working papers, and illustrations necessary to perform credit union audits and supervisory examinations;
- The AICPA Audit and Accounting Guide, *Audits of Credit Unions*;
- The most recent checklists and illustrative financial statements for credit unions.

Quality Control Manual for CPA Firms

The *Quality Control Manual for CPA Firms*, gives you a step-by-step practical approach to establishing and maintaining your quality control system. Written by CPAs who have extensive peer review experience, it provides all of the guidance and forms you will need, without overburdening you with unnecessary and complex documentation. This manual can be used by firms of all sizes, but its simple approach was designed with the small-to-medium-size firm in mind.

Not-for-Profit Organizations Audit Manual

The two-volume *Not-for-Profit Organizations Audit Manual* contains everything you need to conduct high-quality audits—audit programs, forms, checklists, and sample auditor's reports and financial statements developed especially for not-for-profit organization audits. Also discussed in this manual are two recently-released FASB Statements of Financial Accounting Standards on contributions and not-for-profit organizations' financial statements, as well as FASB's proposed exposure draft on investments, the proposed AICPA Statement of Position on joint activities, and the AICPA's proposed Audit and Accounting Guide for not-for-profit organizations. The manual also helps you efficiently test the compliance requirements of the Yellow Book and OMB Circular A-133.

Auto Dealership Engagement Manual

The *Auto Dealership Engagement Manual* guides you through the twists and turns of an auto dealership audit. Developed to help you conduct effective and efficient engagements in this turbulent industry, it provides guidance that until now has been lacking. This manual includes:

- Two audit approaches—the All Substantive Approach for primarily substantive audits and the unique "ABC System" for audits in which it is efficient to test controls;
- An overview of the industry, including operating characteristics;
- Tailored audit programs and internal controls questionnaire;
- Discussion of auto dealership's unique accounting principles and practices;
- Sample auditor's reports and financial statements; and
- Tax information, including complex LIFO calculations and extended warranty service revenue recognition rules.

SOFTWARE — THE ELECTRONIC EDGE

The AICPA's software products — ATB Write-Up, Accountant's Trial Balance (ATB) and its modules, Audit Program Generator (APG), Engagement Manager (EM) and Depreciation, among others — put the solutions to daily practice problems at your fingertips. Together with the Engagement Manuals, they streamline engagement planning and performance, and enable you to more effectively monitor your staff and your budget. Most importantly, they prevent you from reinventing the wheel each time you plan and conduct an engagement.

It's easy to put these products to work for you. The software requires an IBM PC, XT, AT, PS/2 or IBM-compatible system and DOS version 3.1 or higher. A team of professionals is available to answer any of your questions; simply call the Software Support Hotline at 800-226-5800 or use the Software Express FAX service at 800-226-6868.

ATB Write-Up

ATB Write-Up features powerful options that let you analyze information and generate reports and financial statements quickly and easily. ATB Write-Up takes all of the power and flexibility of ATB, ATB Financial Statements, and ATB Consolidations and adds to it. ATB Write-Up offers:

- **Period Reporting** — Use up to 13 periods per year. This gives you the flexibility to generate annual, semiannual, quarterly or monthly reports.

- Departmental Reporting — Set up as many departments as you need. ATB Write-Up will print most workpapers and reports by department, in total for all departments, or for a selected range of departments.
- Financial Statements — Up to 16 columns, each custom-definable to include periods, departments, year-to-date, percentages, add columns together, and more.
- Consolidations — Link and combine accounts of related groups into one consolidated company.

Accountant's Trial Balance

ATB, the best-selling, most-used accounting software in the profession today, is an integral part of the IPS family. Designed *by* accountants *for* accountants and used by approximately 9,000 accounting firms, ATB automates much of the routine work associated with trial balance and financial statement preparation. Specifically, it:

- Generates picture-perfect working papers, including trial balances, journals, lead schedules, user-definable grouping schedules, and analytical review worksheets;
- Enables users to prepare trial balances based on GAAP, federal tax, state tax, or other user-selected accounting bases;
- Keeps up to five years of data on file for any one client, enabling you to generate a variety of comparative reports quickly and simply.

Modules for Use with ATB 3.0

- *ATB Financial Statements* — This powerful report writer enables you to produce final financial statements quickly and easily.
- *ATB Consolidations* — This module enables you to consolidate trial balances from up to nine individual companies into one ATB company trial balance — with ATB automatically keeping track of all activities.
- *ATB Conversion* — With ATB Conversion you can transfer any data electronically from a number of general ledger and working paper packages to ATB and from ATB to leading corporate tax preparation packages.

Audit Program Generator

The Audit Program Generator (APG) enables you to customize an audit program or a checklist to a particular client. Its unique features help you save time and unnecessary expense in conducting audits. Since its introduction in 1987, over 8,000 firms have used APG.

APG Version 2.0 enables you to —

- Create a variety of programs and checklists, including audit programs, disclosure checklists, and compliance checklists;
- Tailor the audit program to the needs of your specific client;
- Customize programs from a wide variety of sample AICPA work programs available in electronic format;
- Quickly link your audit procedures and financial statement assertions;
- Use a full-text editor to customize titles and footers and create appropriate tabular formats.

Engagement Manager

The Engagement Manager (EM) software package can assist you in planning, analyzing, documenting, and correcting engagement management problems — and free up valuable staff time in the process. Most importantly, it handles the details of creating and modifying budgets, recording actual time and expenses, and comparing results so you can devote your energy to other aspects of your business. With EM's help, you can:

- Anticipate potential budget variances and delays through a variety of analytical reports;
- Spot potential problems while there is time to take action;
- Determine the effectiveness of individual staff members by analyzing their efficiency in assigned areas.

Depreciation

Depreciation provides a simple and efficient means of calculating and tracking how assets are depreciated. It calculates depreciation for six separate reporting bases: book, federal, state, AMT, ACE, and "other." What's more, it lets you apply various methods of depreciation to any of these reports and prints out complete worksheets showing changes in various property accounts and the necessary journal entries to record depreciation for the year. Now, with its pull-down menus, Depreciation is easier to use than ever.

Reports generated through AICPA Depreciation include:

- Depreciation schedules by category, G/L account number, system, or convention
- Summarized worksheet information for Forms 4255, 4562, 4626, 4797, 6252, and Schedule D
- AMT preference calculation
- ACE adjustment calculation
- Fully depreciated assets report
- Amortization report
- Section 179 deduction report
- ITC-taken report
- Basis comparison
- Depreciation account reconciliation
- Amortization account reconciliation
- Schedule M-1 information
- Overridden calculations

TRAINING RESOURCES: MAKING THE INTEGRATED PRACTICE SYSTEM WORK FOR YOU

Whether you're a user of one or more of the Integrated Practice System products or you're looking for ways to more effectively manage engagements, Training Resources can benefit you. You'll learn how the Engagement Manuals and Software can help your practice run more smoothly and how the system works to facilitate productivity, efficiency, and quality performance by you and your staff.

The Training Resources come in three formats: self-study or self-administered group study; customized in-house group study; and conferences. Here is what's available in each format:

Self-Study or Self-Administered Group Study

An Orientation and Technical Update Seminar is a formal group study-program designed to assist firms with initially implementing the Integrated Practice System Engagement Manuals. It also provides a monitored self-study orientation on the manuals for new staff. The seminar materials can help you to better understand and apply common SASs in the most efficient manner. You'll learn how to design tests, auditing procedures and sample sizes to collect the right amount of evidence needed for particular engagements.

Accountant's Trial Balance — CPE Edition is a self-study course that teaches you how to automate your working papers for all types of engagements. You'll earn eight hours of CPE credit as you become familiar with ATB and its most used features for audits, reviews, compilations, and tax working papers.

Accountants Trial Balance With Financial Statement Generator — CPE Edition is a self-study course that enables you to rapidly learn the basics of ATB and the Financial Statement Generator add-on module. The recommended CPE credit for this course is eight hours.

Customized In-House Group Study

Special in-firm training is available to demonstrate how your firm can put the Integrated Practice System products to use. And you'll see immediate results. That's because the training leader will use a current client engagement *you select* as the training model. Whether you select a one- or two-day training program, you'll learn how IPS products can help you address real client needs and resolve specific client problems.

AICPA Conferences

Training sessions focusing on the Engagement Manuals are part of many AICPA conferences designed for local and regional practitioners, including the highly rated PCPS Conference and the National Accounting and Auditing Advanced Technical Symposium.

To schedule in-firm training or to obtain more information about the Integrated Practice System Training Resources, including dates and locations of these conferences, call the AICPA Technical Information Division at (201) 938-3060.

PREFACE

The AICPA *Small Business Audit Manual* is a complete tool kit to plan, perform, and report on an audit of financial statements of a small business. The overall approach to performing small business audits presented in this Manual is designed to maximize quality and efficiency. The audit approach used in the *Small Business Audit Manual* includes a system's walk-through to familiarize the auditor with the client's accounting system and facilitate performance of analytical procedures, tests of balances, and verification of the financial statement assertions.

This Manual is designed to comply with all applicable accounting and auditing pronouncements. References are made throughout to the authoritative pronouncements and cited to section numbers in AICPA *Professional Standards* and the FASB *Accounting Standards — Current Text*. Practitioners are encouraged to refer directly to the applicable technical literature.

The Manual's thorough documentation system is an integral part of a firm's overall quality control system. All the forms and checklists are explained and illustrated in the Manual. A separate documentation package containing all the blank forms and working papers to facilitate reproduction is included with the Manual.

This two-volume Manual contains all the documentation necessary to complete a small business audit engagement, arranged in the order it normally will be needed in the engagement:

- Client Acceptance and Continuance Form
- Sample engagement letter
- Altman Z Score Computation Form
- Small Business System's Walk-Through Documentation Form
- Internal Control Structure Reportable Conditions Form
- Materiality Computation Form
- Sampling documentation
- Audit Planning Memorandum
- Small Business Analytical Procedures and Tests of Balances Audit Programs
- Summary of Possible Journal Entries Form
- Small Business Audit Reporting and Disclosure Checklist
- Documentation of the EDP System (for both in-house and service-center-produced records)
- Management Meeting Checklist and sample communication of internal control structure matters
- Illustrative correspondence and working papers
- Illustrative auditors' reports

In addition, the Manual contains quality control and management and supervision documents:

- Consultation Form
- Client representation letter
- Engagement performance and technical review checklists
- Financial Statement Control Form
- Budgeting and time control documents

The *Small Business Audit Manual* maximizes opportunities for additional services. In addition to the new chapter on consulting service, the Manual's checklists and other documentation are sources of meaningful suggestions that can be presented to clients and that ultimately may result in the performance of additional services.

Achieving both engagement quality and profitability requires extensive planning. The *Small Business Audit Manual's* forms, checklists, and decision matrixes are documents that require planning to begin before any field work is done and to continue until engagement completion. The planning documents included in the Manual allow for timely engagement partner review and involvement in the audit program design and execution. Preparing and reviewing documentation helps develop skills of the in-charge and other staff and helps to identify problems early.

The *Small Business Audit Manual* is designed to permit maximum flexibility in the approach to engagements. All the audit programs are designed to be modified to fit the client circumstances encountered.

ABOUT THE AUTHOR

GEORGE L. MARTHINUSS, JR., CPA, CFP

George Marthinuss, CPA, CFP, is president of CPE Institute, Inc. and a former partner in the regional firm of Keller, Zanger, Bissell & Company in Rockville, MD. He has over 25 years of experience in public accounting for national, regional, and local firms.

Mr. Marthinuss holds an MBA from the University of Maryland, where he was also an instructor and the faculty advisor to Beta Alpha Psi. Mr. Marthinuss is past chairman of the AICPA Accounting and Review Services Committee and formerly served on the AICPA CPE Curriculum & Quality Control Subcommittee. He is an active member of the Institute of Certified Financial Planners, the International Association of Financial Planning, the Construction Financial Management Association, and the Suburban Maryland Building Industry Association.

SUGGESTED REVISIONS TO SMALL BUSINESS ORGANIZATIONS AUDIT MANUAL

Please submit all suggestions to improve the quality of the *Small Business Audit Manual* as they arise. We value users' input and will give all comments consideration when revising the manual.

To:
Susan Menelaides, CPA, Director
Technical Information Division
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

From:

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Suggested Revisions:

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(Please attach additional sheets if necessary)

AUDIT MANUAL ADVISORY TASK FORCE

The manuals in the AICPA Integrated Practice System are monitored by a special PCPS Audit Manual Advisory Task Force. Task force members use the manuals in their audit and accounting practices and continuously provide the AICPA staff with recommendations to enhance the manuals from the perspective of the small- and medium-sized firm.

MEMBERS OF THE AICPA PRIVATE COMPANIES PRACTICE SECTION (PCPS) AUDIT MANUAL ADVISORY TASK FORCE

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PEER REVIEW OF THE AICPA INTEGRATED PRACTICE SYSTEM

SMALL BUSINESS AUDIT MANUAL

In keeping with our commitment to give you reliable practice aids, we engaged the CPA firm, Baird, Kurtz & Dobson, to perform a peer review of the *Small Business Audit Manual*. Using quality control materials that have been peer reviewed serves two purposes: (1) it provides reasonable assurance that the materials are reliable practice aids for conducting audits in accordance with professional standards; and (2) it helps to minimize the cost of your firm's peer review.

A copy of Baird, Kurtz & Dobson's unqualified peer review report follows this page. This report has been accepted by the Private Companies Practice Section and the SEC Practice Section of the AICPA's Division for CPA Firms. Although the report addresses the 1994 edition of this Manual, it is valid for three years.



January 24, 1995

The Board of Directors
American Institute of Certified
Public Accountants

**Baird,
Kurtz &
Dobson**

Certified
Public
Accountants

We have reviewed the system of quality control for the development and maintenance of the 1994 edition of the *Small Business Audit Manual* (materials) of the AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA) in effect for the year ended December 31, 1994 and the resultant materials in effect at December 31, 1994, in order to determine whether the materials are reliable aids to assist users in conforming with those professional standards the materials purport to encompass. Our review was conducted in accordance with the standards for reviews of quality control materials promulgated by the peer review committees of the Private Companies Practice Section and the SEC Practice Section of the AICPA Division for CPA Firms.

In performing our review, we have given consideration to the following general characteristics of a system of quality control. An organization's system for the development and maintenance of quality control materials encompasses its organizational structure and the policies and procedures established to provide the users of its materials with reasonable assurance that the quality control materials are reliable aids to assist them in conforming with professional standards in conducting their accounting and auditing practices. The extent of an organization's quality control policies and procedures for the development and maintenance of quality control materials and the manner in which they are implemented will depend upon a variety of factors, such as the size and organizational structure of the organization and the nature of the materials provided to users. Variance in individual performance and professional interpretation affects the degree of compliance with prescribed quality control policies and procedures. Therefore, adherence to all policies and procedures in every case may not be possible.

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

In our opinion, the system of quality control for the development and maintenance of the quality control materials of the AICPA was suitably designed and was being complied with during the year ended December 31, 1994 to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in conforming with those professional standards the materials purport to encompass. Also, in our opinion, the quality control materials referred to above are reliable aids at December 31, 1994.

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**AICPA INTEGRATED PRACTICE SYSTEM
SMALL BUSINESS AUDIT MANUAL**

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CHAPTER 1

INTRODUCTION

1.000 PURPOSE OF MANUAL

1.001 The purpose of this Manual is to provide engagement-oriented documentation for use in small business audit engagements. While the documentation and references in this Manual are integral parts of a CPA firm's quality control system, they are not intended to serve as a complete or comprehensive quality control system.

1.002 This Manual is designed as a nonauthoritative practice aid. It is intended to provide users with practical how-to guidance in applying authoritative accounting and auditing literature in their nonpublic small business audit engagements. Audits of publicly held entities and other special engagements will require additional procedures and documentation.

1.003 The sample audit programs, forms, and checklists included in this Manual should be tailored to each engagement's circumstances, and also to the firm's quality control policies and procedures. Also, to ensure that audit objectives are met on each engagement, the documentation should be modified by the in-charge and approved by the engagement partner before any field work is started.

1.100 DEFINITION OF SMALL BUSINESS

1.101 AICPA Auditing Research Monograph No. 5, *Audit Problems Encountered in Small Business Engagements*, defines a small business as one having some or all of the following characteristics:

- Ownership or operational control is concentrated in the hands of one or a few individuals, creating owner/manager dominance.
- Management personnel or employees have limited accounting knowledge.
- Management believes it cannot or need not hire employees that have accounting knowledge.
- A higher potential for management override of internal control procedures exists.
- Internal control deficiencies result from:
 - Limited segregation of functions within the accounting system because of the small number of employees.
 - Easy access to physical assets by clerical and administrative personnel.
 - Informally designed procedures for planning, budgeting, accounting, and reporting that are dependent on management style.
- The company has an inactive or ineffective policy-making body.



1.102 Firm experience or familiarity with clients having some or all of these characteristics may provide the following information that can lead to greater efficiency in the current year's engagement:

- Tests of controls from previous audits may have produced a significant number of misstatements. Substantive tests had to be performed to compensate for unacceptable results of tests of controls.
- The nature of the small business client generally makes high reliance on substantive tests more cost-effective. For example, it may be more cost-effective to confirm a substantial portion of receivables and sales than to perform extensive tests of controls and thereby limit confirmation of receivables and other tests of sales.

1.103 While the characteristics of a small business described above will apply to many clients, the results of a cost/benefit analysis should be the primary reason for choosing the small business audit approach described in this Manual. In other words, this small business audit approach should be used in engagements for which it is deemed the most efficient. A companion product in the AICPA Integrated Practice System, the *Comprehensive Engagement Manual*, uses two different audit approaches, the ABC System, which provides guidance for conducting audits in which it is beneficial to perform tests of controls and thereby reduce substantive testing, and the All-Substantive Approach, which provides guidance when it is more beneficial to perform primarily substantive tests.

1.200 CONTENTS OF MANUAL

1.201 This Manual contains all the documentation necessary to complete a small business audit engagement. The documentation is arranged in the order in which it will normally be used in an engagement. One chapter is allocated to each document, or group of related documents, and most of the chapters contain the following standard divisions:

- Description of purposes of the document
- Discussion of authoritative pronouncements related to the document
- Guidance on how to use the document
- Illustrative copy of the document

1.202 The contents of this Manual are intended for use as practice guidelines. The documents should be applied in practice only after considering the applicable promulgations of the AICPA, the Financial Accounting Standards Board (FASB), and other recognized authorities. The information in this Manual is not a substitute for exercising professional judgment and due care in performing audits and preparing reports.

New Chapter for 1995

1.203 Chapter 21 added this year, highlights certain consulting services an auditor can provide to small business clients such as assisting them in obtaining funds and advising on general ledger software selection.

1.300 SMALL BUSINESS DOCUMENTATION PACKAGE

1.301 This Manual is designed to be used with the accompanying Small Business Documentation Package. This package includes blank copies of all the filled-in sample documentation materials included in this Manual.

1.400 SMALL BUSINESS AUDITING PHILOSOPHIES

1.401 The following small business auditing philosophies are embodied in this Manual:

- Extensive planning should take place in all small business audit engagements.
- Engagement personnel should be involved when their expertise can contribute to the quality and efficiency of the engagement.
- The most cost-efficient approach to performing small business audit engagements should be selected based on each engagement's circumstances.
- The small business audit approach includes a system's walk-through to achieve an understanding of the client's internal control structure policies and procedures that will facilitate the performance of analytical procedures, the tests of balances, and the verification of the financial statement assertions.
- The system's walk-through is designed to obtain information that will corroborate other tests or procedures performed to assess overall engagement risk and risk of potential misstatements.
- The overall engagement risk and the risk of potential misstatements will determine the acceptable risk of incorrect acceptance that, when correlated with the planned reliance on specific tests of balances procedures and the estimated population misstatement amounts, will influence the tests of balances sample sizes.
- Reliance will be placed on analytical procedures to the maximum extent practical.
- For engagements with low overall engagement risk and a level of control risk slightly less than maximum, less reliable procedures and smaller sample sizes may be used for certain substantive tests. Some substantive tests may also be performed at interim dates.
- High reliance will be placed on tests of balances unless the balance is not material, or unless the financial statement assertions have been substantially verified by analytical procedures.
- Information obtained from the system's walk-through should be communicated to management in the form of suggestions for improvement and used as a source of additional services for the firm.

1.500 AUTHORITATIVE PRONOUNCEMENTS

1.501 Statements on Auditing Standards (SASs) and interpretations of the SASs of the AICPA Auditing Standards Board, Statements on Quality Control Standards (SQCSs) of the AICPA Quality Control Standards Committee, Statements of Position (SOPs) of the AICPA Auditing Standards Division and



AICPA Accounting Standards Executive Committee, and Statements of Financial Accounting Standards (SFASs), Interpretations (FASBIs), and Emerging Issues Task Force Consensuses (EITFs) of the FASB, and other authoritative literature should be consulted when performing auditing services. While some authoritative pronouncements may apply primarily to publicly held companies, generally, there is no separate set of standards for nonpublic companies. The existing literature for publicly held companies may be considered when performing audits of nonpublic companies.

1.502 Throughout this manual, references to the publications containing authoritative literature have been included to help users in performing research. The explanation of these references follows:

AC = Accounting standards in the FASB *Accounting Standards — Current Text*

AU = Auditing standards in the AICPA *Professional Standards*, Volume 1

ET = Ethics standards in the AICPA *Professional Standards*, Volume 2

QC = Quality control standards in the AICPA *Professional Standards*, Volume 2

Updating of the Manual

1.503 This manual is updated annually to provide users the most current authoritative guidance. This edition reflects the authoritative guidance issued through July 21, 1995, including those issued up to:

- SAS No. 74
- SFAS No. 122
- FASBI No. 41
- SOP 95-2
- FASB Technical Bulletin No. 94-1
- EITF Consensuses adopted up to and including the July 21, 1995 Emerging Issues Task Force meeting

1.504 Users should be alert for pronouncements issued subsequent to those listed above that could affect their engagements.

Practice Tip:

AICPA Audit and Accounting Guides, published in looseleaf and bound book format, describe the accounting and financial reporting practices of specific industries, as well as matters relating to audits of financial statements of entities in those industries. They include illustrative financial statements and auditors' reports that address matters unique to the industries. There are currently 27 Guides covering a variety of industries and engagements, including:

- Agricultural Producers
- Banks
- Certain Nonprofit Organizations
- Construction Contractors
- Employee Benefit Plans
- Federal Government Contractors
- Providers of Health Care Services
- State and Local Governmental Units

1.600 RECENT AUDITING PRONOUNCEMENTS**The GAAP Hierarchy**

1.601 In January 1992, the AICPA's Auditing Standards Board issued SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AU 411), which revised the existing hierarchy of generally accepted accounting principles (GAAP). Statement on Standards for Accounting and Review Services No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992*, clarifies that the new hierarchy also applies to compilation and review engagements.

1.602 SAS No. 69:

- Created two separate but parallel hierarchies—one for state and local governments and another for nongovernmental entities.
- Established a true GAAP hierarchy. Unlike the old SAS, each successive category in the hierarchy is a different level of authority.
- Elevated the authority of FASB Emerging Issues Task Force (EITF) consensuses and AICPA Practice Bulletins from "other literature" to "established accounting principles."

1.603 Paragraph 16 of SAS No. 69 (AU 411.16) summarizes the pronouncements that are included in each of the five categories of GAAP for nongovernmental entities and for state and local governments.



1.604 SAS No. 69 is effective for reports on financial statements for periods ending after March 15, 1992. Generally, the levels of authority apply to pronouncements with effective dates after March 15, 1992. However, EITF consensuses issued before March 16, 1992 also are effective for initial application of an accounting principle after March 15, 1993.

Importance of EITF Consensuses

1.605 The one-year grace period assigned to the old EITF consensuses was designed to give accountants an opportunity to become acquainted with over 150 consensuses that were outstanding as of March 15, 1992. The EITF Consensuses that have the widest applicability and relevance to small business engagements are summarized below.

1.606 Selected EITF Consensuses Outstanding as of March 15, 1992

Issue No. Title and Issue

Balance Sheet Classification

- 85-1 *Classifying Notes Received for Capital Stock*
Should notes received in exchange for capital stock be classified as an asset or as a reduction of equity?
- 86-30 *Classification of Obligations When a Violation is Waived by the Creditor*
How is the classification of long-term debt affected when the creditor waived existing debt covenant violations but retained future, periodic covenant requirements?

Contingencies

- 86-12 *Accounting by Insureds for Claims-Made Insurance Policies*
Should an enterprise record an incurred-but-not-reported (IBNR) liability for uninsured losses resulting from claims-made insurance policies?

Environmental Treatment Costs

- 89-13 *Accounting for the Cost of Asbestos Removal*
When may the costs of asbestos removal be capitalized, and, if expensed, may the costs be classified as an extraordinary item?
- 90-8 *Capitalization of Costs to Treat Environmental Contamination*
Should environmental contamination treatment costs be expensed or capitalized? Supplements Issue No. 89-13.

Extinguishment of Debt

- 86-18 *Debtor's Accounting for a Modification of Debt Terms*
Should the exchange of a new noncallable debt instrument for an older callable debt instrument be accounted for as an extinguishment of the older debt issue?

◆ **89-15** *Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties*

Should the exchange of new debt for existing debt with the same creditor (at terms which are lower than the prevailing market rate) be considered an extinguishment of debt by the debtor?

Income Taxes

87-8 *Tax Reform Act of 1986: Issues Related to the Alternative Minimum Tax*

How should the alternative minimum tax be accounted for under Accounting Principles Board Opinion No. 11 and SFAS Nos. 96 and 109?

88-4 *Classification of Payment Made to IRS to Retain Fiscal Year*

How should partnerships and Subchapter S corporations record payments made to the IRS to retain their fiscal year?

91-8 *Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax*

How should a state franchise tax that is partly based on an income tax be accounted for under SFAS Nos. 96 and 109?

Insurance

88-5 *Recognition of Insurance Death Benefits* consensus reached on issue No. 1 only

May income from death benefits on corporate-owned life insurance policies be recorded immediately on an actuarially expected basis rather than deferred until the insured's death?

Inventory

86-46 *Uniform Capitalization Rules for Inventory Under the Tax Reform Act of 1986*

Are the types of costs that must be allocated to inventory for tax purposes also capitalizable under GAAP?

Leases

88-10 *Costs Associated with Lease Modification or Termination* consensus reached on issues Nos. 2 and 3 only

When should costs associated with lease modification or termination be expensed?

Marketable Securities

86-40 *Investments in Open-End Mutual Funds That Invest in U.S. Government Securities*

Should investments in mutual funds that hold debt securities be accounted for at the lower of cost or market or amortized cost?

Nonmonetary Transactions

- 86-29 *Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value*
Should the magnitude of boot affect whether an exchange of nonmonetary assets is accounted for at the recorded amounts or fair value?
- 87-29 *Exchange of Real Estate Involving Boot*
Does SFAS No. 66 apply to exchanges of similar real estate involving boot that is at least 25% of the fair value of the exchange?

Real Estate

- 88-24 *Effect of Various Forms of Financing under FASB Statement No. 66*
How should profit be recognized under SFAS No. 66 when a real estate transaction involves various forms of financing?

Revenue Recognition

- 88-18 *Sales of Future Revenues*
Should cash received in exchange for a promise to pay future revenues from a segment, product line, or other asset be classified as debt or deferred income? How should any foreign currency effects be recognized?

1.608 Selected EITF Consensuses Adopted from March 15, 1992 to July 21, 1995

Environmental Liabilities

- 93-5 *Accounting for Environmental Liabilities*
When should recoveries be considered in measuring the amount of a contingent liability relating to environmental matters? Under what circumstances may an environmental liability be discounted?

Business Combinations

- 95-3 *Recognition of Liabilities in Connection with a Purchase Business Combination*
In a purchase business combination, when should (1) costs to exit an activity of an acquired company, and (2) involuntary employee termination benefits and relocation costs be accrued as liabilities under APB Opinion No. 16, *Business Combinations*? What additional financial statement disclosures should the employer make related to these charges?

Leases

- 93-8 *Accounting for the Sale and Leaseback of an Asset That is Leased to Another Party*
How does a seller-lessee account for a sale/leaseback of personal property when the asset is subject to an operating lease at the time of sale or is subleased or intended to be subleased by the seller-lessee to a third party under an operating lease?

◆

95-4 *Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease*

Is a manufacturer precluded from recognizing a sale of a product to a dealer if the customer subsequently enters into an operating lease with the manufacturer or its finance affiliate who acquires that product subject to a lease?

Income Taxes

93-12 *Recognition and Measurement of the Tax Benefit of Excess Tax-Deductible Goodwill Resulting from a Retroactive Change in Tax Law*

When an institution elects to retroactively amortize goodwill in accordance with the Omnibus Budget Reconciliation Act of 1993, how is the tax benefit related to tax-deductible goodwill in excess of "book" goodwill determined? How should that benefit be recognized under FASB Statement No. 109, *Accounting for Income Taxes*?

93-13 *Effect of a Retroactive Change in Enacted Tax Rates That is Included in Income from Continuing Operations*

Should the tax effect of a retroactive change in enacted tax rates for the period that includes the enactment date of the change be measured using temporary differences existing at the date of enactment or those existing at the effective date of the tax rate change?

94-10 *Accounting by a Company for the Income Tax Effects of Transactions among or with its Shareholders under FASB Statement No. 109, Accounting for Income Taxes*

Should tax effects caused by transactions among or with shareholders be included in the income statement or in equity in the separate financial statements of the company affected?

Nonmonetary Transactions

93-11 *Accounting for Barter Transactions Involving Barter Credits*

Does APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, apply to an exchange of a nonmonetary asset for barter credits?

Postretirement Benefits Other Than Pensions

93-3 *Plan Assets under FASB Statement No. 106*

If a trust is established to pay postretirement benefits, must the trust assets be "bankruptcy-proof" to qualify as plan assets under SFAS No. 106?

Restructuring Charges

94-3 *Accounting for Restructuring Charges*

When should a liability be recognized for costs of termination benefits, as defined in the consensus, to be provided to involuntarily terminated employees? What related disclosures should be made for all periods until the termination plan is completed? (Note: At press time, the EITF had reached consensus on only selected issues relating to restructuring charges. Remaining issues will be discussed and additional consensus may be reached at future meetings. Therefore, practitioners should consult the looseleaf edition of *EITF Abstracts* or call the AICPA Technical Hotline to obtain current information on this issue.)



Debt

94-8 *Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring*

In a debt restructuring, if there is a difference in the basis in the loan being restructured and the fair value of the debt security received, what should be the creditor's initial cost basis of a debt security received from the original debtor in a loan restructuring and how should the creditor account for any differences between his basis in the loan and the fair value of the security at the date of the restructuring?

Stock Options

94-6 *Accounting for the Buyout of Compensatory Stock Options*

When compensatory stock options are repurchased by the issuing company, how should the total amount of compensation cost recognized as expense be determined?

Transfer of Receivables with Recourse

92-2 *Measuring Loss Accruals By Transferors for Transfers of Receivables with Recourse*

When receivables are sold with recourse, should the transferor accrue all probable credit losses over the life of the transferred receivables at the sale date? May the recourse obligation be discounted if the timing of the cash flows can be reasonably estimated?

1.700 RECENT AUTHORITATIVE PRONOUNCEMENTS

1.701 This section includes descriptions of recently issued or proposed pronouncements with the widest applicability and relevance to small businesses. Recent pronouncements not considered relevant to most small businesses are not included herein.

Fair Value and Derivatives Disclosures

1.702 SFAS No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* was issued to improve the financial reporting of derivatives. SFAS No. 119 is effective for calendar year 1994 financial statements, except for entities with less than \$150 million in total assets, for which it is effective for calendar year 1995 financial statements. SFAS No. 119 expands and amends the requirements of SFAS No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and 107, *Disclosures about Fair Value of Financial Instruments*. First, it expands the disclosure requirements of SFAS No. 105 to include additional types of derivatives, such as options held. It also amends SFAS No. 107 as follows:

- If fair value information is located in more than one note, a summary table of fair value information should be included.
- Fair value and carrying amount should be disclosed together.
- Disclosures should clearly designate whether the derivatives are assets or liabilities.

- Information should clearly relate to balance sheet line items.
- Fair value information should not be combined or netted with non-derivatives (except if netting is permitted under FIN No. 39).

1.703 The Statement requires the following additional disclosures:

For derivatives held or issued for trading purposes (generally applies only to financial institutions that deal in derivatives):

- The average fair value balance of positions during the reporting period and ending fair value, and the net gains or losses resulting from trading activities.
- Identification of the derivative from which the gains or losses arose, and where those amounts are reported in the income statement.

For derivatives held or issued for purposes other than trading:

- The objectives of holding or issuing the derivatives.
- Recognition and measurement policies.
- How they are reported in the financial statements (balance sheet and income statement locations).
- If the derivatives are used to hedge anticipated transactions, a description and time period for the transactions, the classes of the derivatives, deferred gains and losses, and the events that would cause gains and losses to be recognized.

1.704 Financial statement presentation and disclosure requirements of SFAS No. 119 are included in the Small Business Audit Reporting and Disclosure Checklist in Chapter 14, section 14.300.

Impairment

1.705 SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* was issued in March 1995 and is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is prohibited. The Statement establishes accounting standards (including measurement and disclosure requirements) for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets for assets to be held and used and assets to be disposed of. SFAS No. 121 amends several existing pronouncements (see paragraphs 20-33 of the Statement).

1.706 Assets to Be Held and Used. According to the Statement, an entity is required to review its long-lived assets, such as buildings and equipment, for impairment whenever events or changes in circumstances relating to the assets ("triggering events") indicate that the carrying amount of an asset may not be recoverable. In other words, an event or change in circumstances, such as a significant decrease in the market value of an asset, a significant change in the extent or manner in which an asset is used, or a significant physical change in an asset, may indicate that an asset has been impaired.

1.707 If a triggering event has occurred, the entity then determines if an impairment loss should be recognized by measuring the expected future cash flows (undiscounted and without interest charges) to be generated from the use of the asset and its eventual disposition. If the sum of the expected future cash flows is less than the carrying amount of the asset, then an impairment loss should be recognized.

1.707a The amount of the impairment loss to be recognized is measured by calculating the difference between the carrying amount and the fair value of the asset. The fair value is defined as the amount at which the asset could be bought or sold in a current transaction between willing parties. If quoted market prices in active markets are not available, SFAS No. 121 discusses various methods of determining the fair value of the assets, including using estimates of expected future cash flows discounted at a rate commensurate with the risks involved.

1.707b Once an impairment is recognized, the reduced carrying amount of the asset is the new cost basis that should be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

1.708 Assets to Be Disposed Of. If management has committed to a plan to dispose of long-lived assets (whether by sale or abandonment), has the authority to approve the action, and this action is not considered a disposal of a segment under APB Opinion No. 30, the assets should be reported at the lower of carrying amount or fair value, less costs to sell. Fair value is measured the same as for assets to be held and used. The costs to sell an asset includes incremental direct costs, such as broker commissions, legal and title transfer fees, and closing costs. Assets to be disposed of should not be depreciated while they are held for disposal.

1.709 Subsequent revisions to the estimates of fair value should be reported as adjustments to the carrying amount of the assets, not to exceed the carrying amount (original basis less accumulated depreciation or amortization) of the assets before the adjustment was made.

1.710 Financial statement presentation and disclosure requirements of SFAS No. 121 are included in the Small Business Audit Reporting and Disclosure Checklist in Chapter 14, section 14.300.

Risks and Uncertainties

1.711 SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* was issued in December 1994 in response to a need for improved disclosure of significant risks and uncertainties brought about by a volatile business and economic environment. Many of the disclosure requirements of this SOP supplement or overlap the requirements of other authoritative pronouncements, primarily SFAS No. 5, *Accounting for Contingencies*. The SOP is effective for calendar year 1995 financial statements, and for interim periods in fiscal years subsequent to the year the SOP is first adopted. It applies to financial statements of all nongovernmental entities prepared in accordance with GAAP.

1.712 The disclosure requirements of SOP 94-6 fall into four categories:

All entities should report—

- (1) Nature of operations

- (2) Use of estimates in preparing financial statements

Only entities that meet certain conditions should report—

- (3) Certain significant estimates
(4) Current vulnerability due to certain concentrations

1.713 Because the disclosure requirements of this SOP overlap with many other disclosure requirements, they may be combined or grouped with other related disclosures.

1.714 Nature of Operations. SOP 94-6 requires that an entity describe its major products or services and principal markets, including the location of those markets. If the entity operates more than one business, it should also disclose the relative importance of each business and the basis for determining the relative importance, such as assets, revenues, or earnings. It is not necessary to quantify the relative importance of different operations; instead, importance can be conveyed by terms such as "predominantly," "about equally," and "major."

1.715 Sample disclosures of nature of operations for a small business follows:

- Retail Franchisor of Sporting Goods

Sporting Goods Headquarters, Inc. (the Company) was incorporated in Arizona in January 19X1. The Company operates retail sporting goods stores and grants franchises for the operation of retail sporting goods stores under the name of Sports Headquarters. At December 31, 19Y5, the Company had ten franchise locations and three company-owned stores.

- Manufacturing Company

PipeCo, Inc. located in Houston, Texas, manufactures tubing and related products. The Company sells primarily to manufacturers of oil field equipment and leisure products that are located in the Southwestern United States.

1.716 Use of Estimates in the Preparation of Financial Statements. Disclosures should include a statement that financial statements prepared in accordance with GAAP require the use of management's estimates. The following disclosure, found in paragraph A-9 of the SOP, can generally be used verbatim to satisfy this requirement:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.



1.717 Certain Significant Estimates. Disclosure of information about estimates is required if two criteria are met: (1) it is reasonably possible that an estimate about a condition existing at the balance-sheet date will change in the near term (one year from the balance-sheet date) and (2) the effect of the change would be material to the financial statements. Examples of estimates that are often sensitive to material change are:

- Inventory and specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Valuation allowances for commercial and real estate loans
- Environmental cleanup-related liabilities
- Litigation-related obligations
- Contingent liabilities for obligations of other entities
- Amounts reported for pensions and postemployment benefits
- Amounts reported for long-term contracts.

1.718 The disclosures for certain significant estimates supplement those in SFAS No. 5, *Accounting for Contingencies*. However, the SOP applies not just to estimates related to contingencies, but also to other types of estimates, such as those related to the carrying value of assets and liabilities (e.g., long-term construction contracts). Also, the SOP introduces the concept of a "near term" change in the estimate, while SFAS No. 5 makes no distinction between "near term" and long-term changes in estimates.

1.719 As mentioned above, this disclosure need only be made if two criteria are met:

- 1) *It is at least reasonably possible that an estimate about a condition that existed at the balance-sheet date will change in the near term.* The SOP draws on the SFAS No. 5 definition of reasonably possible, which is "more than remote but less than likely." Therefore, the likelihood that an estimate will change in the near term should be at least "more than remote." In considering whether the estimate is sensitive to change in the near term, the entity should consider only facts and circumstances known to management before the financial statements are issued.

To illustrate, consider a construction contractor's long-term contracts. Estimated costs to complete includes a particular material, and management is aware at year-end that a shortage and resulting price increase for this material may occur in the next few months. If the likelihood of the price increase in the near term is more than remote, then this disclosure criterion is met.

- 2) *The effect of the change would be material to the financial statements.* Determining whether the effect of a change in estimate would be material to the financial statements is a matter of judgment, and presumably involves the same judgment used to determine whether other items are material to the financial statements. Also, note that the SOP refers to materiality in relation to the effect of the change, not to the estimate. For example, consider an entity that has not recorded a valuation allowance for inventory subject to rapid technological

obsolescence. Even though no estimate is recorded, the entity might need to disclose the fact that it is reasonably possible that a material change in the estimate is likely to occur in the near term.

1.720 If an estimate meets the disclosure requirements of SOP 94-6, the following matters should be disclosed:

- The nature of the uncertainty and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.
- If the estimate involves a loss contingency covered by SFAS No. 5, an estimate of the possible loss or range of loss, or a statement that such an estimate cannot be made. (Note that this requirement overlaps with SFAS No. 5 disclosure requirements for loss contingencies. In fact, for such items, the only disclosure added by SOP 94-6 is the statement that it is at least reasonably possible that a change in the estimate will occur in the near term.) Also, the SOP recommends, but does not require, disclosing the factors that cause the estimate to be sensitive to material change.

1.721 Current Vulnerability Due to Certain Concentrations. The SOP requires disclosure of certain concentrations if: (1) the concentration exists at the balance-sheet date, (2) the concentration makes the entity vulnerable to the risk of a near-term severe impact, and (3) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term. (As mentioned earlier near term is defined as a period not to exceed one year from the balance-sheet date.)

1.722 This disclosure is required only if all of the following criteria are met:

1. *The concentration existed at the balance-sheet date.* The SOP specifically identifies the types of concentrations that should be considered for this disclosure:
 - Concentrations in the volume of business transacted with a particular customer, supplier, or lender;
 - Concentrations in revenues from particular products or services;
 - Concentrations in the available sources of supplies of materials, labor or services (paragraph 24 of the SOP requires some specific disclosures for labor subject to collective bargaining agreements), or of licenses or other rights used in the entity's operations; and
 - Concentrations in the market or geographic area in which the entity operates (paragraph 24 of the SOP requires some specific disclosures for foreign operations).
2. *The concentration must make the entity vulnerable to the risk of a near-term severe impact.* The key concept (and probably the most difficult one) in applying this criterion is the concept of "severe impact." Paragraph 7 of the SOP defines severe impact as:

A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity...The concept of severe impact, however, includes matters that are less than catastrophic.

As with materiality, determining whether something would constitute a severe impact requires judgment. For example, consider a manufacturer that buys all of its raw materials from one supplier. The loss of this supplier would cause significant production delays and greater than material losses of revenues, yet other suppliers can provide similar raw materials under similar terms. Thus, although losing this supplier could have a significant financially disruptive effect on the normal functioning of the entity, it would not cause bankruptcy because the entity could ultimately turn to other suppliers and resume normal operations.

3. *It is at least reasonably possible that the event that could cause the severe impact will occur in the near term.* As noted above, the SOP uses the SFAS No. 5 definition of reasonably possible of "more than remote but less than likely." Thus, the probability threshold for disclosure of a concentration is the same as that for disclosure of a loss contingency.

1.723 It is important to note that the SOP indicates that two types of concentrations are always considered to meet this "reasonably possible" criterion: (1) concentrations of customers, grantors, or contributors; and (2) concentrations of operations in foreign countries.

1.724 If any concentrations meet these criteria, paragraph 24 of the SOP states that disclosure "should include information that is adequate to inform users of the general nature of the risk associated with the concentration." An example of a disclosure for a concentration related to customers follows:

At December 31, 19X5, receivables from three customers were about 45% of trade accounts receivable, and sales to these customers comprised 40% of total sales for the year then ended.

1.725 The Small Business Audit Reporting and Disclosure Checklist in Chapter 14, section 14.300, has been updated to include the disclosure requirements for SOP 94-6.

1.726 Audit Considerations for SOP 94-6. Since entities must adopt SOP 94-6 for their December 31, 1995 financial statements, auditors of those entities will need to ensure that the client has disclosed the nature of its operations, the use of estimates in preparing financial statements, certain significant estimates, and certain concentrations. The first two disclosures should be fairly straightforward. In fact, many companies already disclose information about the nature of their operations. The more difficult challenge for auditors will be to determine if circumstances that trigger the other two disclosures—certain significant estimates and current vulnerability due to certain concentrations—exist and, if they do, whether the disclosures are appropriate.

1.727 Generally, much of the information auditors obtain during the normal course of the audit provides a good foundation for determining whether the client has estimates and concentrations that require disclosure. Specific procedures directed towards SOP 94-6 may include:

Certain Significant Estimates:

- Obtain or prepare a listing of any estimates used in determining the carrying values of assets and liabilities and gain and loss contingencies that are sensitive to change. Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate.

Examples of such estimates include:

- inventory and specialized equipment subject to technological obsolescence
 - valuation allowances for deferred tax assets based on future taxable income
 - valuation allowances for commercial and real estate loans
 - environmental cleanup-related liabilities
 - litigation-related obligations
 - contingent liabilities for obligations of other entities
 - amounts reported for pensions and postemployment benefits
 - amounts reported for long-term contracts
- Consider whether it is at least reasonably possible that a material change in the estimate will occur in the near term.
 - If such a situation is identified, review support for the calculation of the effect of the change.

Certain Concentrations

- Obtain or prepare a listing of the following types of concentrations, if any, that existed at the balance-sheet date and that make the entity vulnerable to risk of near-term severe impact (severe impact is a higher threshold than materiality, but less than catastrophic). Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate:
 - volume of business transacted with a particular customer, supplier, or lender
 - revenues from particular products or services
 - available sources of supply of materials, labor or services, or of licenses or other rights used in operations
 - market or geographic area in which the entity conducts its operations
- Determine whether it is at least reasonably possible that an event will occur in the near term that would cause the severe impact.

1.728 The Tests of Balances Audit Program includes steps for considering the completeness and accuracy of the SOP 94-6 disclosures.

Investment Partnerships

1.729 On May 19, 1995, the AICPA's Accounting Standards Executive Committee issued SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*. This SOP applies to financial statements of investment partnerships exempt from SEC registration under the Investment Company Act of 1940 (with certain exceptions) when such statements are prepared in conformity with GAAP.

1.730 The SOP provides guidance on financial statement presentation and disclosure of investments, income, and partners' capital, including requirements to:

- Include a condensed schedule of investments in securities,

- Present a statement of operations in conformity with the requirements for statements of operations of management investment companies in the Audit and Accounting Guide, *Audits of Investment Companies*, and
- Disclose in the notes the method of computing payments or allocations to the general partner for management fees and present the amounts of such payments in either the statement of operations or the statement of changes in partners' capital.

1.731 The SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Limited Liability Companies

1.732 In April 1995, the AICPA's Accounting Standards Executive Committee issued Practice Bulletin (PB) No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships*, which requires that financial statements of a limited liability company (LLC) should:

- Be similar in presentation to those of a partnership,
- Be clearly identified as those of a limited liability company, and
- Disclose any limitations of members' liability, and different classes of members' interests and respective rights, preferences and privileges of each class.

1.733 The PB, which includes additional accounting, reporting, and disclosure requirements, is effective for financial statements issued after May 1995.

Auditing Interpretations

1.734 *The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events (AU 9411.11-.15)*. This Interpretation establishes guidance on what the auditor should consider when determining the appropriateness of an accounting principle adopted by management for material new types of transactions or events for which there are no established sources of accounting principles. The Interpretation states that when the auditor is evaluating the principle, he or she should assess the appropriateness of management's basis for selecting the principle by considering whether there are:

- Analogous transactions or events for which there are established accounting principles, or
- Other accounting literature.

1.735 *Auditing Interpretation, Audits of Financial Statements That Had Been Previously Audited by a Predecessor Auditor (AU 9315.08-.18)*. This Interpretation of SAS No. 7, *Communication Between Predecessor and Successor Auditors*, was issued in April 1995. It provides guidance to an auditor who is auditing and reporting on financial statements previously audited and reported on by a predecessor auditor (referred to as "reauditing"). The Interpretation states that:

- The auditor should request the predecessor auditor's workpapers for the year under audit and for the prior year.

- The review of these workpapers and inquiries of the predecessor auditor do not in themselves constitute sufficient competent evidential matter to provide a basis for expressing an opinion on the financial statements.
- The successor auditor should not divide responsibility for the work performed in his or her report.
- The successor may consider the information obtained from inquiries of the predecessor and any review of the predecessor's working papers and report in planning a reaudit.
- The successor auditor must become satisfied with the existence of beginning physical inventories by making or observing physical counts of inventories after the reaudit period and performing "roll back" procedures, test intervening transactions, such as testing prior transactions, reviewing prior count records, and performing analytical procedures. The auditor may not use the predecessor's inventory or other work for these purposes.

1.736 *Describing Tests of Operating Effectiveness and the Results of Such Tests, (AU 9324.01-.03) and Service Organizations that Use the Services of Other Service Organizations (Subservice Organizations) (AU 9324.04-.18).* These Interpretations of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, were issued in April 1995. The first provides guidance to a service auditor as to how much detail and what information should be included in the description of "tests applied" and the "results of the tests." The latter provides guidance for the user auditor and the service auditor when the service organization uses a subservice organization.

1.737 *Reporting on a Special-Purpose Financial Statement that Results in an Incomplete Presentation But Is Otherwise in Conformity with Generally Accepted Accounting Principles (AU 9326.80-.87).* This Interpretation defines what constitutes a contractual agreement under AU 623, *Special Reports*, and which guidance within the standards should be followed under different "special reporting" situations. It also provides guidance when the auditor is to distribute the report to additional parties that were not part of the original contract or agreement.

1.738 *Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report (AU 9341.01-.02).* This Interpretation addresses the situation where auditors are asked to reissue reports that included a going-concern explanatory paragraph because the situation or condition that gave rise to substantial doubt about the entity's ability to continue as a going-concern has been resolved. This Interpretation provides guidance for auditors who agree to reissue their reports in such instances. It's important to note that the Interpretation does not *require* auditors to reissue their reports, however, if the auditor does agree to reissue his or her report, he or she should:

- Audit the event or transaction that prompted the request for reissuance,
- Perform procedures in paragraph 12 of AU 560, Subsequent Events, at or near the date of reissuance, and
- Consider factors described in paragraphs 6-11 of SAS No. 59, based on the conditions and circumstances at the date of issuance.



Proposed Statements

1.739 Amendment to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. In February 1995, the AICPA Auditing Standards Board issued a proposed amendment to SAS No. 55 that would incorporate the internal control concepts found in *Internal Control—Integrated Framework Report* (often referred to as the "COSO report"). Specifically, the amendment would change the current definition of internal control in SAS No. 55 from "control environment, accounting system, and control procedures" to the definition in the COSO report, "control environment, risk assessment, control activities, information and communications, and monitoring." The AICPA Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, will also be revised simultaneously. The final documents are expected to be issued in December 1995, and are expected to be effective for audits of entities with fiscal years beginning January 1, 1997. This amendment is not expected to have a significant impact on practical applications of SAS No. 55.

1.740 Proposed amendment to SAS No. 58, *Reports on Audited Financial Statements*. The proposed amendment was released in July 1995 and would eliminate the requirement to add an explanatory paragraph to the auditor's report for certain uncertainties. This amendment would not affect the requirement in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to add such a paragraph for going-concern uncertainties. If approved, the final SAS is expected to be issued in December 1995, and would be effective for reports issued on or after June 30, 1996.

1.741 To determine the current status of these proposed amendments, call the AICPA's Technical Hotline at 800-862-4272, menu option 2.

1.742 Proposed Statement of Position, *Environmental Remediation Liabilities (Including Auditing Guidance)*. The proposed SOP, which provides guidance on the recognition, measurement, display and disclosure of certain environmental remediation liabilities was released in June 1995 by the AICPA Accounting Standards Executive Committee. Among other things, the SOP requires that environmental remediation liabilities be accrued when the criteria of SFAS No. 5 are met, and it includes benchmarks to aid in determining when such liabilities should be recognized in accordance with SFAS No. 5.

Among the costs to be included in the measurement of the liability are:

- a. Incremental direct costs of the cleanup effort,
- b. Costs of compensation and benefits for employees to the extent they will devote time directly to the cleanup effort, and
- c. Certain costs of legal work related to the cleanup effort.

The proposed SOP would be effective for financial statements beginning after December 15, 1995.

1.800 USE OF FORMS IN ELECTRONIC FORMAT

1.801 WordPerfect. Enclosed with this Manual is a complementary disk that contains the sample engagement letters, representation letters, sample auditor's reports, and other correspondence illustrated in this Manual. The documents in the disk are in WordPerfect format to allow you to easily customize them for each client.

1.802 Lotus 1-2-3. Also included on the complementary disk is the Summary of Possible Journal Entries Form in Lotus 1-2-3 (release 3.1 with wysiwyg or release 3.4 and higher). This file allows you to easily post unrecorded misstatements and it contains formulas to calculate totals and percentages. If you do not have access to Lotus 1-2-3, you may copy the Form included in the section 10.500 of Chapter 10 for inclusion in your workpapers.

1.803 These documents are identified in the Manual by the following icon:



1.804 Audit Program Generator. Many subscribers to the Integrated Practice System (IPS) Engagement Manuals are also users of the AICPA's Audit Program Generator (APG), a specially designed software program that allows you to customize a variety of AICPA work programs and checklists for each client.

1.805 If you are already an APG user, you may purchase the Library Volume containing the programs and checklists (such as the Tests of Balances Programs and the Small Business Audit Reporting and Disclosure Checklist) included in this Manual. To order APG and/or the APG Libraries for the IPS Engagement Manuals, call the AICPA's Order Department at 1-800-862-4272, sub-menu #1 and ask for the Library Volume for the *Small Business Audit Manual*. For APG product information, call the AICPA Software Connection at 1-800-226-5800.

1.806 The programs and checklists that are available in the APG Library Volume are identified by the following icon:



CHAPTER 2
APPROACH TO PERFORMING SMALL BUSINESS ENGAGEMENTS

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CHAPTER 2

APPROACH TO PERFORMING SMALL BUSINESS ENGAGEMENTS

2.000 INTRODUCTION

2.001 This Manual presents practical assistance to auditors of small business entities, whether the auditors develop their own forms, questionnaires, programs, and workpapers, or whether they use those provided throughout this Manual.

2.002 This chapter presents a unique approach to small business audit planning and performance—an approach designed to minimize substantive testing and thereby maximize engagement profits. The Manual provides the forms, questionnaires, programs, and workpapers needed to meet the planning and documentation requirements, as well as to determine the most cost-effective way to conduct the engagement.

2.003 The efficiency of small business audit engagements may relate to any or all of the following:

- a. The size of the client's operations, in both physical and monetary terms.
- b. The number of audit hours normally necessary to complete the engagement.
- c. The number of client accounting and management personnel and their qualifications.
- d. The adequacy of the client's accounting system.
- e. The adequacy of the client's internal control structure policies and procedures.

2.100 USING THE SYSTEM'S WALK-THROUGH APPROACH

2.101 The System's Walk-through Approach is designed to maximize audit quality and efficiency when substantive tests are considered more efficient than tests of controls (TOCs)—that is, when the elimination of TOCs can save more time than that required by corresponding increases in analytical procedures and tests of balances (TOBs). The approach is summarized as follows:

- a. Control risk is assessed at the maximum for all assertions.
- b. TOCs are considered inefficient.
- c. The System's Walk-through Approach is used to gain an understanding of the internal control structure.
- d. High reliance is placed on analytical procedures, and TOBs are modified as necessary.

2.102 The following evidence modification matrix should be used to guide the System's Walk-through Approach to small business audits:

Evidence Modification Matrix

<u>Engagement Risks</u>	<u>Reliance on Types of Tests</u>		
	<u>System's Walk-through</u>	<u>Analytical Procedures</u>	<u>TOBs</u>
1. Either a high overall engagement risk, a high risk of potential misstatements, or both.	Understanding only	High	High
2. Both a low overall engagement risk and a low risk of potential misstatements.	Slight	High	Slightly less than High, to High

2.103 Variations in reliance on types of tests relate primarily to the nature, extent, and timing of auditing procedures. High reliance requires using the most reliable procedures, selecting large sample sizes, and performing tests of balances and analytical procedures at or near the balance-sheet date. Slightly less than high reliance may permit less reliable procedures, smaller sample sizes, and the performance of certain analytical and tests of balances procedures at interim dates.

2.104 The risk analysis must be made by transaction cycle and related to the corresponding tests of balances audit areas. See the illustrative Small Business System's Walk-Through Documentation Form in chapter 5, section 5.600, for an example of the effect of risk on the engagement design process.

2.105 When both categories of risk are low (as is the case in number 2 of the Evidence Modification Matrix in section 2.102) the reliability of the procedures may be reduced in part, sample sizes may be reduced somewhat, and certain tests of balances procedures may be performed as of an interim date.

2.106 Consider, for example, the audit areas affected by the sales and collections cycle, that is, accounts receivable and sales. High reliance would normally mean sending positive confirmations to all individually significant customer account balances on the balance-sheet date. The lower limit on individually significant items would be relatively small so that the dollar amount of the accounts selected would compose a significant portion of the account balance, say, 60 to 70 percent. Sales (by product if possible) would be scheduled by month and trends compared for three or four years; variances would be investigated.

2.107 Reducing the reliance on these substantive tests for low risks in both categories could permit a higher lower limit on individually significant items; that is, individually significant items would compose a smaller portion of the population. A small number of negative confirmations could be selected for representative accounts from the remaining population. Assuming procedures outlined in AICPA Statement on Auditing Standards (SAS) No. 45, *Substantive Tests Prior to the Balance-Sheet Date* [AU 313.01-.10], are performed, it may also be possible to confirm receivables as of an interim date. The

detailed analysis of sales by product and by month may only be necessary in low risk circumstances if analytical procedures identify problems or unexplained variances.

2.108 The evidence design process in this approach begins with the assumption that high reliance on analytical procedures and tests of balances will be required on small business audits. If, however, the overall engagement risk based on the Client Acceptance and Continuance Form (Chapter 3, section 3.400), and the risks of potential misstatements assessed during the system's walk-through are low, the nature, extent, and timing of tests of balances may be modified to reflect a slightly less degree of reliance.

2.109 Section 2.110 provides a starting-point guidance for modifying reliance on tests of balances in circumstances of low risk. This illustration reflects the typical nature, extent, and timing of procedures that would normally be performed when either overall engagement risk or risk of potential misstatement is high, and provides an alternative for cases when both risks are low.

2.110 Illustrative Small Business Tests of Balances Procedures

Program Design Considerations

<u>Major Audit Area</u>	<u>High Reliance</u>	<u>Slightly Less Than High Reliance</u>
1. Cash	<ol style="list-style-type: none"> 1. Prove all major bank reconciliations at the balance-sheet date. Trace most reconciling items to cutoff statements. Confirm all accounts. Search for unrecorded transfers. 	<ol style="list-style-type: none"> 1. Perform the same tests due to the high risk inherent in cash balances.
2. Trade accounts receivable and sales	<ol style="list-style-type: none"> 2a. Send positive confirmations, and/or perform alternative procedures for individually significant accounts representing a substantial portion of the account balances as of the balance-sheet date. Support nonreplies and exceptions by reference to sales and cash receipts documents. Consider sending positive confirmations on a few representative remaining accounts. 	<ol style="list-style-type: none"> 2a. Select fewer items as individually significant items for positive confirmation.
	<ol style="list-style-type: none"> 2b. Perform extensive sales cutoff tests by referring to sales and shipping documents. 	<ol style="list-style-type: none"> 2b. Shorten the test period or raise the lower limit of items tested.
	<ol style="list-style-type: none"> 2c. Compare sales by month, by product, to preceding year. Follow up on significant fluctuations by reviewing underlying records. 	<ol style="list-style-type: none"> 2c. Sales procedures are basically the same.
3. Inventories and costs of sales	<ol style="list-style-type: none"> 3a. Consider observing inventory from start to finish. Make test counts of all individually significant items. 	<ol style="list-style-type: none"> 3a. Depending on the client's controls over count, raise the lower limit of individually significant items for test counts.
	<ol style="list-style-type: none"> 3b. Perform inventory pricing and clerical tests for all individually significant items. 	<ol style="list-style-type: none"> 3b. Depending on the client's double-check procedures for pricing, extending, and footing the inventory sheets, consider reducing the number of individually significant items tested.

Illustrative Small Business Tests of Balances Procedures
(Continued)

Program Design Considerations

Major Audit Area

High Reliance

Slightly Less Than High Reliance

- | | | |
|---------------------|--|--|
| 4. Fixed assets | 4. Perform extensive vouching and inspections. A significant portion of the additions should be subjected to support tests. | 4. Raise the lower limit of individually significant items subjected to vouching and inspection (that is, vouch fewer items). |
| 5. Accounts payable | 5a. Perform an extensive search for unrecorded liabilities, including subsequently recorded transactions, open invoices, and receiving report and purchase order files. Lower limits for individually significant items should be used. Consider confirming major suppliers, including zero balances.

5b. Perform extensive purchases cutoff tests by referring to vendor invoices for a long period before and after balance-sheet date. | 5a. Perform the same tests due to high inherent risk of unrecorded payables.

5b. Shorten the test period or raise the lower limit of individually significant items tested. |
| 6. Expense accounts | 6. Scan expense ledgers for unusual entries and perform extensive vouching tests for all significant accounts. Vouch entries by examining cancelled checks and supporting documents. | 6. Expense procedures are basically the same. |
| 7. Payroll accounts | 7. Compare monthly payroll by labor category and follow up on variations by referring to underlying records. Consider reconciling gross wages to payroll tax returns and, if necessary, testing a few selected disbursements in detail. | 7. Basically, the same procedures can be performed, except detailed tests can be eliminated. |

2.111 Terms such as *extensive*, *substantial*, and *significant*, are, of course, subjective. Their application will vary in each engagement's circumstances and will depend on such considerations as materiality, the inherent nature of transactions and balances, and the overall mix of evidence. These terms are used here to indicate that when the System's Walk-through Approach is used to obtain an understanding of the internal control structure, tests of balances and analytical procedures are the primary sources of evidence to corroborate the financial statement assertions. If, for example, the evidence on an engagement previously consisted of a mix of tests of controls, tests of balances, and analytical procedures, eliminating the tests of controls would not mean the auditor would need less evidence. It would simply mean that more evidence from tests of balances, analytical procedures, and other procedures would be required, since the overall evidence necessary for the required level of assurance would remain the same.

2.200 PLANNING

2.201 The third general standard of rule 201 of the AICPA Code of Professional Conduct (ET 201.01C) requires that AICPA members "adequately plan and supervise the performance of professional services." Also, the first field work standard of generally accepted auditing standards requires that "the work is to be adequately planned and assistants, if any, are to be properly supervised."

2.202 SAS No. 22, *Planning and Supervision* (AU 311), provides guidance to auditors on the considerations and procedures applicable to planning and supervision, including preparing an audit program, obtaining knowledge of the entity's business, and dealing with differences of opinion among firm personnel.

2.203 Achieving both engagement quality and profitability requires extensive planning. Engagement planning begins at the acceptance of the engagement and continues until the completion of the engagement. The engagement partner should be involved at strategic times during the engagement. Early and frequent partner involvement in program design, and in related judgment decisions, will help develop the in-charge and other staff, identify problems before the job starts, and result in the highest quality, most profitable engagement in the circumstances.

2.204 The following table provides guidance for on-going planning throughout a small business audit engagement:

On-going Planning Procedures

<u>Function</u>	<u>Responsibility</u>	
	<u>In-charge</u>	<u>Engagement Partner</u>
1. Pre-engagement planning conference of engagement partner and in-charge	1. Discuss briefly the nature of the engagement and anticipated problems.	1. Apprise in-charge of any current client developments.

On-going Planning Procedures
(Continued)

<u>Function</u>	<u>Responsibility</u>	
	<u>In-charge</u>	<u>Engagement Partner</u>
2. Understanding the client's business and industry	2a. Prepare or update Client Acceptance and Continuance Form.	2a. Review Client Acceptance and Continuance Form and assessment of overall engagement risk.
	2b. Review prior year's working papers, report, and management letter.	
	2c. Assess overall engagement risk.	
3. Engagement letter	3a. Identify the nature of the engagement and additional services to be performed.	3a. Meet with client, discuss letter, and obtain signature.
	3b. Prepare engagement letter.	
4. Planning analytical procedures	4. Complete the Planning Analytical Procedures section of the Audit Planning Memorandum.	4. Review documentation.
5. System's walk-through procedure	5. Complete the Small Business System's Walk-Through Documentation Form and the Small Business Microcomputer Installation Survey Form, if applicable.	5. Review documentation.
6. Overall materiality limit	6. Compute overall materiality limit and lower limit for individually significant items. Enter overall materiality limit on Summary of Possible Journal Entries Form.	6. Review computations.
7. Sample size selection	7. Determine individually significant items and select samples as appropriate. Complete Sampling Decision Working Paper.	7. Review working papers.
8. Time budget preparation	8. Revise preliminary budget prepared at conclusion of prior year's engagement.	8. Review time budget.
9. Planning conference of engagement partner and in-charge	9. Prepare Audit Planning Memorandum and discuss Nos. 2 through 8 with engagement partner.	9. Review Audit Planning Memorandum and discuss Nos. 2 through 8 with in-charge.

On-going Planning Procedures*(Continued)*

<u>Function</u>	<u>Responsibility</u>	
	<u>In-charge</u>	<u>Engagement Partner</u>
10. Pre-year-end meeting with staff	10. Discuss engagement, client, and staff work responsibilities.	10. Observe.
11. Analytical procedures	11. Modify and complete Analytical Procedures Program.	11. Review results of Analytical Procedures Program.
12. Year-end tests of balances	12a. Modify and complete TOB Audit Program.	12a. Review results of TOB procedures.
	12b. Review work of assistants.	
13. Final analytical procedures	13. Perform final analytical procedures.	13. Review revised results of final analytical procedures.
14. End of field work conference with engagement partner and in-charge	14. Discuss evidence collected and resulting conclusions on the engagement.	14. Discuss evidence collected and resulting conclusions on the engagement.
15. Post-engagement meeting with staff	15. Discuss engagement results and plans for next year.	15. Observe.

Meetings With Staff

2.205 Good on-the-job training philosophies will normally include these components:

1. Pre-engagement meetings with staff.
2. Frequent supervision and review of assistants' work.
3. Post-engagement meetings with staff.

2.206 Such meetings give the staff the benefit of work performed by the in-charge prior to the meeting to achieve an understanding of staff's work responsibilities and anticipated engagement problems, and to explain the engagement administration.

2.300 COMPLETING THE ENGAGEMENT

Functions and Responsibilities

2.301 Completing the engagement efficiently requires control and organization. The following illustration outlines the major functions and responsibilities for engagement completion.

Completing the Engagement

Function	Responsibility	
	In-charge	Engagement Partner
1. Completion of engagement performance review	1. Complete Engagement Performance Review Checklist.	1. Review Engagement Performance Review Checklist.
2. Preparation of financial statements, notes, and report	2. Draft financial statements, notes, and report. Complete Small Business Audit Reporting and Disclosure Checklist.	2. Review financial statements, notes, report and Small Business Audit Reporting and Disclosure Checklist.
3. Report review conference of engagement partner and in-charge	3. Discuss engagement partner's review.	3. Discuss engagement partner's review.
4. Preparation and presentation of management communication	4. Prepare meeting letter or meeting agenda to communicate control structure related and other matters.	4. Review and present letter or hold meeting with management.
5. Administrative wrap-up	5. Complete the engagement.	5. Complete the engagement.

Completing the Engagement Review

2.302 The in-charge is responsible for reviewing all work of assistants, completing the Engagement Performance Review Checklist (Chapter 13, section 13.411), and obtaining the engagement partner's review.

Financial Statements, Notes, and Report Preparation

2.303 Section 14.217 and the Small Business Audit Reporting and Disclosure Checklist (Chapter 14, section 14.300) contain guidance for the in-charge when drafting financial statements, notes, and reports.

Report Review Conference With Engagement Partner

2.304 This conference between the engagement partner and in-charge should be the final technical function for the engagement. Accomplishment of the engagement objectives, conformance with firm policy, problem resolution, and the financial statements and report form and content should be the primary subjects discussed. This is the final key-point review for engagement quality.

Preparation and Presentation of Management Communication

2.305 A pinnacle of the service approach to engagement philosophy, the communication of internal control structure related matters, is required on all audits. As a cost-efficient alternative to a written communication, a meeting may be held with management to communicate reportable conditions and operational suggestions. See Chapter 16 for more information about operational suggestions.

2.306 Making operations or management-related suggestions contributes to a firm's success by—

- Providing additional documentation of the client's control procedures.
- Training staff to think like businesspersons.
- Demonstrating a genuine interest in helping clients achieve their objectives.
- Helping clients identify needs for additional services.
- Selling additional services.

2.307 The Management Meeting Checklist (Chapter 16, section 16.300) may be used to prepare for the management meeting or for a written communication regarding control structure related and other matters. The results of any meeting with client personnel should be documented in the working papers, or a memorandum should be prepared by the in-charge or engagement partner.

Communication of Internal Control Structure Related Matters

2.308 SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* [AU 325.02], states:

During the course of an audit, the auditor may become aware of matters relating to the internal control structure that may be of interest to the audit committee. The matters that this Statement requires for reporting to the audit committee are referred to as *reportable conditions*. Specifically, these are matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. Such deficiencies may involve aspects of the internal control structure elements of (a) the control environment, (b) the accounting system, or (c) control procedures.

2.309 This communication can be either written or oral; however, if such matters are communicated orally, SAS No. 60 requires that the auditor document the matters discussed in the working papers. Reportable conditions may be obtained from the Small Business System's Walk-Through Documentation Form, from the results of procedures performed during the audit, or from observations of engagement personnel. They should be summarized in the Internal Control Structure Reportable Conditions Form (Chapter 6, section 6.300). A tentative draft of any written communication should be reviewed with management. If a written communication is prepared, the following wording from SAS No. 60 should be used:

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

(Include paragraphs to describe the reportable conditions noted.)

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the entity (or specified regulatory agency or other specified third party).

2.310 Often, as a benefit to their clients, auditors communicate matters that are not related to the internal control structure, such as operational and administrative deficiencies. SAS No. 60 allows auditors to include such comments in a report on internal control structure related matters, and although not required, the authors recommend that such comments be separately identified and segregated from reportable conditions.

Material Weaknesses

2.311 SAS No. 60 defines a material weakness as:

a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

2.312 In other words, material weaknesses are reportable conditions that are of such a magnitude that it is likely that an error or irregularity having a material effect on the financial statements could occur and not be detected by the client's internal control structure.

2.313 The auditor is not required to separately identify material weaknesses, or to segregate them from other reportable conditions, as this determination may not be important; however, in certain situations (such as when there are many material weaknesses to be identified) it may be preferable to do so.

2.314 When no material weaknesses are included with reportable conditions, the auditor may use the following format for a written communication:

(Include the first paragraph in the report in section 2.309.)

(Include paragraphs to describe the reportable conditions noted.)

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.

(Include the final paragraph in the report in section 2.309.)

2.315 To avoid misunderstandings, a written communication indicating that no reportable conditions were noted during an audit should not be issued.

Administrative Wrap-Up of Engagements

2.316 The administrative wrap-up of small business audit engagements should include the following functions:

1. Schedule and complete all levels of review.
2. Obtain all signed correspondence.
3. Furnish the client with copies of, and obtain approval for, final adjustments.
4. Clear and dispose of all review and "to do" points.
5. Prepare a working paper for things to do and time savings for next year.
6. Monitor the processing and delivery of the report, the communication of internal control structure related matters, and the tax returns.
7. Complete and discuss staff and in-charge performance appraisals.
8. Complete time summaries, budget comparisons, and tentative budget for next year.

CHAPTER 3
CLIENT ACCEPTANCE AND CONTINUANCE

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CHAPTER 3

CLIENT ACCEPTANCE AND CONTINUANCE

3.000 INTRODUCTION

3.001 Although most firms want to expand their client base, this expansion should be carefully monitored to ensure that accepting a prospective client and continuing a relationship with an existing client will not harm the firm's reputation and standing in the community.

3.002 The AICPA Statement on Quality Control Standards (SQCS) No. 1, *System of Quality Control for a CPA Firm*, requires CPA firms to establish a system of quality control. Included in a system of quality control should be policies and procedures for accepting and continuing clients. Specifically, paragraph 7 of SQCS No. 1 (QC 10.07) states:

Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity.

3.003 Firms should develop, preferably in writing, quality control policies and procedures for evaluating new and existing client relationships that meet its unique organizational and operating characteristics. These policies should specify:

For prospective clients

- The procedures to be followed for evaluating a prospective client, including
 - obtaining and reviewing the prospective client's available financial statements or information.
 - inquiring of third parties, such as the prospective client's attorneys, bankers, etc., about the organization and its management.
 - communicating with the predecessor auditor or accountant.
 - considering circumstances that would require special attention or that present special risks in the engagement.
 - evaluating the firm's independence and ability to serve the prospective client.

- determining whether accepting the client would violate any applicable regulatory agency requirements or the ethics codes of the AICPA or state CPA society.
- The individuals responsible for evaluating prospective clients and making acceptance decisions, and for approving such decisions.
- How appropriate firm personnel are informed of the policies and procedures for accepting clients.
- The individuals responsible for administering and monitoring compliance with the firm's policies and procedures.

For continuing clients

- The procedures followed for evaluating relationships with continuing clients, such as:
 - considering whether significant changes have occurred since the last engagement, such as changes in management, legal counsel, financial condition, or scope of the engagement.
 - considering whether any conditions exist that would have caused the firm to reject the client had they been known at the time of initial acceptance.
- The frequency of such evaluations.
- The individuals responsible for evaluating continuing clients, for deciding whether to continue relationships with existing clients, and for approving such decisions.
- How firm personnel are informed of the firm's continuance policies and procedures.
- The individuals responsible for administering and monitoring compliance with the policies and procedures.

3.004 The Client Acceptance and Continuance Form in section 3.400 is designed to address the basic policies and procedures mentioned above for both new and continuing clients. Sections 3.100 and 3.200 provide detailed discussions of two important considerations included in the Client Acceptance and Continuance Form: evaluation of overall engagement risk and ensuring that the firm and firm personnel are independent with respect to the client.

3.100 OVERALL ENGAGEMENT RISK

3.101 Engagement risk for a client has the following primary components:

- Integrity of management
- Use of financial statements
- Auditability of the entity
- Business environment

Integrity of Management

3.102 Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements*, states, "The financial statements are the responsibility of management." SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, states, "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty." SAS No. 53 also states, "Management integrity is important because management can direct subordinates to record transactions or conceal information that can materially misstate financial statements."

3.103 The integrity of management should be evaluated as part of the client acceptance or retention decision on the Client Acceptance and Continuance Form (section 3.400). Approval of the Client Acceptance and Continuance Form by designated partners indicates that the integrity of management is considered adequate.

3.104 Any significant matters related to management's integrity, arising during the planning and performance of the audit, should be documented in a special memorandum containing a description of:

- The matters designated for further consideration.
- The risk of material misstatement to the financial statements.
- The additional or changed auditing procedures considered necessary to mitigate such risks.
- The results of performing such procedures and their effects on the audit report.

Use of Financial Statements

3.105 The risk associated with the use of financial statements is usually high since auditors cannot control their ultimate distribution or the purposes for which users rely on them. The risk is even higher in circumstances such as the following:

- Statements used in legal proceedings
- Statements used for price-setting in purchases, sales or mergers.
- Statements of construction contractors submitted to bonding underwriters.
- Statement used for obtaining credit.

3.106 The use of financial statements should be documented annually on the Client Acceptance and Continuance Form.

Auditability of the Entity

3.107 A firm should consider the auditability of the entity prior to deciding whether to accept or retain a client. Although a potential client may request an audit and users of the financial statements may require an audit, certain factors may preclude an auditor from being able to express an opinion on the financial statements.

3.108 If a client's accounting system does not provide sufficient evidence to support the recorded transactions, or if the client's accounting records have been destroyed or lost, the entity may be unauditible.

3.109 For a new client, the determination of auditability can usually be determined through discussions with management and the predecessor auditor. The auditor should inquire as to the accounting system and how management determines that the policies and procedures for processing financial information are followed. For a continuing client, auditability is determined by discussions with management as well as through prior experience.

Business Environment

3.110 The auditor should also consider the business environment in which the client operates. Is the nature of the client's business one which the firm does not have the requisite expertise? Is the client in a financial position where bankruptcy, takeover or merger, or sudden collapse could occur? All of these concerns should be addressed when an auditor decides on accepting or retaining a client.

3.200 OTHER ENGAGEMENT MATTERS

Independence

3.201 Auditors must be independent of a client in order to be able to express an opinion on the financial statements. SQCS No. 1 contains a requirement that firms establish quality control policies and procedures that ensure compliance with the professional requirements concerning independence. Specifically, paragraph 7 of this Statement states:

Policies and procedures should be established to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the rules of conduct of the AICPA. Rule 101 of the rules of conduct (ET section 101) contains examples of instances wherein a firm's independence will be impaired.

3.202 Also, the AICPA's *Code of Professional Conduct* "Objectivity and Independence" (ET section 55), states:

A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

3.203 In addition to the basic independence rule found in the *Code of Professional Conduct* are independence interpretations and rulings that address specific situations encountered by accountants. The following are three independence rulings, found in ET Section 191, that apply especially to auditors of small businesses. However, accountants should be familiar with all of the independence rules, interpretations, and rulings.

- Ethics Ruling 191.1, "Acceptance of a Gift" (ET 191.001—.002), indicates that a member may not accept more than a token gift from a client.

- Ethics Ruling 191.3, "Members as Signer or Cosigner of Checks" (ET 191.005—.006), indicates that a member may not accept responsibility of signing or cosigning checks.
- Ethics Ruling 191.4, "Payroll Preparation Services" (ET 191.007—.008), indicates that a member may not perform payroll preparation services for a client if the member is a signer or cosigner of the checks and the member's bank account is used.

3.204 These independence requirements apply not only to AICPA members, but to their spouses and dependents as well. Independence of a member or a member's firm is generally not impaired solely because the member's spouse or a dependent is employed by the client, as long as the employment is in a position that does not allow significant influence over the client's operating, financial, or accounting policies. However, if the employment is in a position in which the person's activities are audit-sensitive (normally an element of or subject to significant internal accounting controls, such as cashier, internal auditor, or accounting supervisor), the auditor's independence would be impaired.

3.205 In addition to establishing policies and procedures to ensure that firms have adequate procedures to determine that their personnel are independent with respect to their clients, the authors believe it is advisable to also ensure that potential independence impairments have been identified and resolved before each engagement begins. As a result, the Client Acceptance and Continuance Form in section 3.400 requires that this determination be made on each engagement before deciding to accept a new client or continue a relationship with an existing client.

Practice Tip:

All practitioners, and the members of their professional staffs, must be thoroughly familiar with the Code of Professional Conduct, the interpretations of ET section 55 that appear in ET section 101, and the related individual rulings that appear at ET section 191 ("Ethics Rulings on Independence, Integrity, and Objectivity").

Potential for Going-Concern Problems

3.206 Financial reporting is based on the assumption that the entity will continue as a going concern, unless there is significant information to the contrary. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341), requires the auditor to evaluate the client's ability to continue as a going concern for a period not to exceed one year beyond the balance-sheet date. To perform this evaluation, the auditor is not required to design audit procedures to detect going-concern problems; rather, the evaluation should be based on information obtained during the course of the audit about conditions or events that indicate that there is substantial doubt about the entity's ability to continue as a going concern. Examples of such conditions or events are negative cash flows, defaults on loan agreements, contraction of service levels, legal proceedings, and operating difficulties.

3.207 If the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, he or she should:

- Consider management's plans to mitigate the effects of the condition or event, and
- Assess the likelihood that the plans can be effectively implemented.

3.208 If substantial doubt remains after evaluating management's plans, the auditor should:

- Consider the adequacy of financial statement disclosures about the going concern problem, and
- Include an explanatory paragraph in the auditor's report to reflect his or her conclusion that there is substantial doubt about the entity's ability to continue as a going concern.

3.209 Whenever the auditor becomes aware of conditions or events that cause him or her to believe that there may be substantial doubt about an entity's ability to continue as a going concern, he or she should document the condition or event, the procedures followed to reach a conclusion about whether substantial doubt exists and, if applicable, the effect on the auditor's report and financial statements. If questions about an entity's ability to continue as a going concern arise in performing pre-engagement and audit planning procedures, they should be documented in the Client Acceptance and Continuance Form and the Audit Planning Memorandum. Questions identified during engagement performance should be documented in a special memorandum that includes a discussion of:

1. The nature of the condition or event that raises a going-concern question.
2. The evaluation of management's plans and other factors, and related audit evidence, that might either mitigate or aggravate the condition or event.
3. The assessment of whether substantial doubt exists about the organization's ability to continue as a going concern.
4. The evaluation of the adequacy of financial statement disclosures of the matters giving rise to the information indicating a going-concern problem and management's plans to mitigate the problem.
5. Any modifications to the auditor's report considered necessary for the uncertainty.

3.210 The following are some conditions and events that may raise a question about an entity's ability to continue as a going concern:

- Recurring operating losses
- Working capital deficiencies
- Default on loans or similar agreements
- Restructuring of debt
- Substantial dependence on the success of a particular project
- Legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate
- Loss of a key customer or supplier

3.211 Altman Z Score. The Altman Z Score, developed by Edward I. Altman,* is a composite formula that is widely used to measure the financial health of a company. The formula takes financial ratios and multiplies each by a specific constant. The computed amounts then are added together to obtain an overall score. If the Total Z Score determined under this calculation exceeds 2.6, the entity probably can be considered sound and secure. If less than 1.1, long-range survival prospects may be in question.

3.212 The Z score can be computed on the Altman Z (Zeta) Score Calculation Form in section 3.500. This score then is compared to scores from other entities to rate relative financial health. Also, the trend of the Z Score should be analyzed to determine whether or not a problem may be developing.

3.213 Practitioners should consider calculating the Z Score when they become aware of the conditions and events listed in section 3.210 that may raise a question about the entity's ability to continue as a going concern.

3.214 Because the Z Score is only one means of measuring an entity's financial health, a CPA firm's quality control policies and procedures should indicate under what conditions, if any, the auditor would make this calculation.

3.215 The results of the Z Score would be documented in the Client Acceptance and Continuance Form and in the Audit Planning Memorandum.

3.300 USING THE CLIENT ACCEPTANCE AND CONTINUANCE FORM

3.301 The Client Acceptance and Continuance Form is designed to help firms evaluate prospective and existing clients. It provides documentation of the evaluation process for new and existing clients, the decision to accept and continue clients, and approval of the decision to accept and continue clients. This Form should be modified as necessary to interface with the firm's quality control policies and procedures for acceptance and continuance of clients.

3.302 For prospective clients, Part I of the Client Acceptance and Continuance Form should be completed by the in-charge and approved by the engagement partner. Part II should be completed by the engagement partner and approved by the partner responsible for approving new clients.

3.303 For existing clients, the in-charge should update and revise the form, as necessary, to evaluate the desirability of continuing the relationship with the client. Multi-year sign-off space is provided to document an annual evaluation and the engagement partner's approval of the continuance (or discontinuance) decision.

*Source: Altman, Edward, *Corporate Financial Distress: A Complete Guide to Predicting, Avoiding, and Dealing With Bankruptcy*, 1983, John Wiley & Sons.

3.400

Client Acceptance and Continuance Form—Part I
--

Client: _____

Financial Statement Date: _____

INSTRUCTIONS:

Part I: Part I of this Form should be completed for all prospective clients for which audit, review, or compilation services are to be performed. The Form should be completed by the in-charge and approved by the engagement partner as a basis for initially accepting the client. Part I should be updated and reviewed annually as a basis for deciding to retain the client.

Part II: Part II of this Form should be completed by the engagement partner and concurring partner to document the firm's decision to either accept or reject the client.

CLIENT'S LEGAL NAME:

ADDRESS:

PHONE:

FEDERAL I.D. NO.:	STATE I.D. NO.:
-------------------	-----------------

1. Describe the nature of the client's business (and locations, if other than above address):

2. Circle the type of entity: corporation, S corporation, proprietorship, LLC, partnership.

**Client Acceptance and Continuance Form — Part I
(Continued)**

3. List key owners, officers, and directors of the client:

Name	Percent Owned	Position	Family Relationship

4. Identify any related businesses or individuals:

Name	Nature of Relationship

5. Identify the client's predecessor accountants:

Name:
Address:
Phone:
Contact Person:

6. Indicate the results of our inquiries of the predecessor accountant regarding the following:

- a. Reasons for change of accountant: _____

- b. Integrity of management and owners: _____

**Client Acceptance and Continuance Form — Part I
(Continued)**

c. Disagreements on accounting principles and auditing, review, or compilation procedures: _____

d. Fee disputes: _____

7. Describe the client's relationships with financial institutions: _____

Institution	Type of A/C's or Loans	Account Executive & Phone

Results of inquiries: _____

8. Describe the services to be provided: _____

Service	How Often?			Report Deadlines
	Monthly	Quarterly	Annually	

Client Acceptance and Continuance Form — Part I
(Continued)

9. Will the financial statements and reports be used for high-risk purposes, for example, reports to regulatory agencies, to obtain or renew significant amounts of credit, to obtain performance bonding, or for sale of the business? Yes ___ No ___ If so, describe: _____

10. Read the latest financial statements and tax returns and indicate findings:

11. Does the client have potential going-concern problems? Yes ___ No ___ If so, describe them:

12. Identify the client's legal counsel:

Name:
Address:
Phone:
Contact Person:

Results of inquiries: _____

Client Acceptance and Continuance Form — Part I
(Continued)

13. State name(s) of other third parties contacted concerning management's and owners' reputation, attitude, ability, and integrity:

14. Describe any significant engagement performance, accounting, or tax problems with which we should be concerned:

15. Describe any pending litigation against the client or its principals:

16. Describe the fee/billing arrangements:



Client Acceptance and Continuance Form — Part I
(Continued)

17. Describe any potential independence problems with respect to the client:

18. Describe any major changes in the above information since our last evaluation of this client. Also describe any other matters that have come to our attention that would have caused us to reject the client had we been aware of them at the time of our initial acceptance of this client:

19____ 19____ 19____ 19____ 19____

Prepared or updated by:
In-charge

Reviewed by:
Engagement Partner

Client Acceptance and Continuance Form—Part II
Client: _____ Financial Statement Date: _____

- | | Yes | No |
|--|--------------------------|--------------------------|
| 1. Is there any reason to doubt the integrity of management (owners)? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Are we aware of any significant disagreements between management or owners and the predecessor accountant? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. Does there appear to be any potential fee collection problems? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Are the client's needs beyond our capabilities or staffing abilities? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. Are we aware of any independence problems that may affect our ability to meet the client's needs? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. Are there high-risk factors related to the engagement that may affect our decision to accept the client? | <input type="checkbox"/> | <input type="checkbox"/> |
| 7. Is there a potential problem with management or owners not fully understanding the limitations of the services to be provided (for example, management's expectation that we will be responsible for the detection of fraud)? | <input type="checkbox"/> | <input type="checkbox"/> |

For any "Yes" answers, explain how we plan to mitigate the problem (for example, by assigning more experienced personnel to the engagement, using outside consultants, obtaining a retainer from the client, etc.):

Acceptance Decision:

Yes _____ No _____

Engagement Partner: _____ Date: _____

Concurring Partner: _____ Date: _____

3.500

Altman Zeta (Z) Score Calculation Form

Client: _____

Financial Statement Date: _____

The Z Score may be used as one indicator of an entity's financial "health" and ability to continue as a going concern. It is used when the auditor becomes aware of conditions and events that raise questions about the entity's ability to continue as a going concern. If Total Z Score determined under this calculation exceeds 2.6, the entity can probably be considered sound and secure. If less than 1.1, long-range survival prospects can probably be considered dim.

The calculation presented here is a general one. Somewhat different calculations, constants, and values apply to manufacturing and service entities. In those cases, additional research should be performed. Adjust the calculations as necessary for the client's situation.

The trend of the Z Score should also be part of the analysis. If a negative trend exists, even though Z Score is in the healthy range, a problem may be developing. On the other hand, if Z Score indicates that survival prospects are not favorable, but the trend is positive, a brighter future may be in store.

This Form should be prepared by the in-charge and reviewed and approved by the engagement partner. The conclusions should be documented in the Client Acceptance and Continuance Form and in the Audit Planning Memorandum.

	Results	×	Constant	=	Value		
					<u>Current</u>	<u>Prior Years</u>	
					19__	19__	19__
1. <u>Working Capital</u> Total Assets	_____	×	6.56	=	_____	_____	_____
2. <u>Retained Earnings</u> Total Assets	_____	×	3.26	=	_____	_____	_____
3. <u>Earnings Before Interest and Taxes</u> Total Assets	_____	×	6.72	=	_____	_____	_____
4. <u>Equity</u> Total Liabilities	_____	×	1.05	=	_____	_____	_____
Total Z Score					=====	=====	=====



ALTMAN ZETA (Z) SCORE CALCULATION FORM
(Continued)

Discuss and evaluate any significant factors that might mitigate a low score (for example, "large back order of business") and list any suggestions that might help entity improve its financial status:

Discuss and evaluate any significant factors (including non-financial items) that might impact upon the entity's ability to continue as a going concern (including loss of significant customers, legal issues or management plans). If necessary, evaluate prospective financial information. Attach all items used.

Conclusion:

19____ 19____ 19____ 19____ 19____

Prepared by:

Reviewed by:

CHAPTER 4
ENGAGEMENT LETTERS

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CHAPTER 4

ENGAGEMENT LETTERS

4.000 PURPOSE OF ENGAGEMENT LETTERS

4.001 Adequate engagement planning includes communicating an understanding of the nature of the firm's services, timing of the field work, report deadlines, responsibilities of the client, and methods of fee determination and payment. The engagement partner should confirm, at least annually, an understanding of the nature of the engagement and the extent of the reporting responsibilities before beginning field work. Such communication will normally include an appropriate engagement letter and a pre-engagement client conference.

4.002 An engagement letter is a contractual obligation to perform and accept responsibility for the services to be provided. Consideration should be given to preparing engagement letters for all significant engagements the firm services.

Practice Tip:

Often, entities that have never been audited resist signing a representation letter. To avoid client resistance at the end of the audit, many firms notify the client in the engagement letter that they will be asked to sign a representation letter, and also include a draft representation letter.

4.100 AUTHORITATIVE PRONOUNCEMENTS

4.101 Currently there are no authoritative pronouncements requiring a written engagement letter for an audit, although most firms regard their completion as good business practice. An engagement letter helps to prevent misunderstandings between the client and the auditor regarding the services to be provided, including the limitations. The engagement letter also sets forth the responsibilities of the client, and in most states it becomes a legally binding contract on both parties. There are other good reasons to obtain an engagement letter, including the following:

- *Reduce the risk of litigation.* Misunderstandings with clients regarding the nature and limitations of the services provided can result in litigation.
- *Avoid misunderstandings by the staff.* The staff performing the work can review the engagement letter to obtain a clear understanding of the services to be provided and the required timing of issuance of the report.

4.200 USE OF THE ENGAGEMENT LETTER

4.201 The engagement letter should be prepared by the in-charge or the engagement partner before any significant work takes place on the engagement. The engagement partner should personally present the letter to the client to ensure that a complete and proper understanding has been achieved. The signed copy should be filed with the current engagement's working papers.

Practice Tip:

Be careful when using a proposal or preliminary engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by you on the engagement. You should always make sure that a final engagement letter is issued in such circumstances, and that a revised letter is issued if the nature of the engagement changes.

4.202 Should the nature of an engagement change during its progress, or should the firm be engaged for additional services during the year, a new engagement letter should be prepared. A step-down to a compilation or review engagement, or a special engagement for preparing a budget and cash flow forecast, are examples of changes that would require a new engagement letter. Such changes should be approved by the engagement partner after careful consideration of the reasons justifying the change. For example, the reasons justifying a step-down from an audit to a compilation or review may prevent the firm from reporting on the lower level of service.

4.203 The content of the engagement letter should include the following:

- Addressee

The letter should be addressed to the board of directors, all partners, or the proprietor. The client should be requested to return a copy of the letter indicating approval by the appropriate person.

- Nature of the engagement

A description of the primary service should be included. Circumstances causing modification of the standard report, subsequent to signing the engagement letter, should be discussed with the client by the engagement partner.

- Additional services

All additional services such as income tax return preparation or consulting services should be described in the letter.

- Unexpected circumstances

Client notification, in the event of unforeseen circumstances, should be mentioned.

- Client's responsibilities

Client assistance such as schedules, financial statements and tax return preparation, and other clerical assistance should be included. It often is detailed in a separate attachment to the engagement letter.

- Fee determination and billing methods

The anticipated fee or fee range may be included. Estimates of fees should be based on conservative, carefully prepared estimates. The expected billing methods and payment periods should be described.

- Signatures

The engagement partner should sign the letter on behalf of the firm. The client representative responsible for the engagement should sign the letter indicating agreement with the contract.

Practice Tip:

When the engagement letter is prepared, the accountant should be mindful to address the financial statements that will be presented. For instance, if a "statement of revenues and expenses" will be issued, the engagement letter should not refer to a "statement of income."

Practice Tip:

If the basis of accounting used by the client is other than GAAP, the engagement letter, auditor's report, and financial statements should state the basis of accounting followed.

4.300 SAMPLE ENGAGEMENT LETTER—AUDIT OF FINANCIAL STATEMENTS [CPA Firm Letterhead]

[Date]

[Client's Name and Address]

Dear _____ :

We are pleased to serve as independent auditors for _____ [client name].

_____ [engagement partner name] will be the partner in charge of all work we perform for you. Auditing and reporting on your annual financial statements will be our basic assignment. We would also like to help you with current problems as they arise throughout the year.

We will audit the Company's financial statements for the year ending _____ [financial statement date] for the purpose of expressing an opinion on them. The proper recording of transactions, safeguarding of assets, and the financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence that supports the amounts and disclosures included in the financial statements. It also includes assessing the accounting principles used and estimates made by management, as well as evaluating the overall financial statement presentation. If, for any reason, we are unable to express an unqualified opinion on the financial statements, we will discuss the alternatives with you in order to arrive at an acceptable solution.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described on a separate attachment. Timely completion of this work will facilitate the completion of our audit.

As part of our engagement for the year ending _____ [financial statement date], we will also prepare the federal and state income tax returns for _____ [client name].

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility, plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees of \$_____.



◆ _____
If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one.

Sincerely,

[Partner's Signature]
[Firm Name]

Accepted and agreed to:

[Client Representative's Signature]

[Title]

[Date]



CHAPTER 5
SMALL BUSINESS SYSTEM'S WALK-THROUGH DOCUMENTATION

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CHAPTER 5

SMALL BUSINESS SYSTEM'S WALK-THROUGH DOCUMENTATION

5.000 PURPOSE

5.001 The purpose of the Small Business System's Walk-Through Documentation Form (section 5.600) is to guide the auditor in obtaining an understanding of the client's accounting system, evaluating the risk of potential misstatements, gathering evidence that will corroborate other tests or information supporting the completeness assertion, designing the mix of evidence, and making suggestions that will assist the client in improving its accounting system.

5.002 The Form should be completed during engagement planning, prior to performing any substantive analytical procedures or tests of balances. Significant weaknesses in the accounting system (that is, high risks of potential misstatements) should be compensated for by expanded analytical and tests of balances procedures.

5.100 AUTHORITATIVE PRONOUNCEMENTS

5.101 Components of the System's Walk-through Approach included in the Small Business System's Walk-Through Documentation Form are considered separately in several pronouncements. AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319), and SAS No. 56, *Analytical Procedures* (AU 329), recognize tests of controls, analytical procedures, and tests of balances as the basic types of tests. Evidence in a given client's circumstances can be obtained from a mix of such tests. The System's Walk-Through Approach uses a mix of evidence from the walk-through, analytical procedures, and tests of balances. When control risk is assessed at slightly less than maximum, because the accounting system is good, the system's walk-through procedure may permit slight reductions in substantive tests. The System's Walk-Through Approach is designed to gather the minimum amount of evidence in each client's circumstances in the least amount of time.

5.102 SAS No. 55, paragraph 2 (AU 319.02), states:

In all audits, the auditor should obtain a sufficient understanding of each of the three elements [of the internal control structure] to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.



5.103 When the auditor assesses control risk at the maximum, neither an internal control questionnaire nor inquiry-type tests of controls are necessary. The System's Walk-Through Approach provides an understanding of the client's control environment and the flow of transactions through its accounting system that is sufficient for audit planning. Completion of the Small Business System's Walk-Through Documentation Form documents this understanding, and helps the auditor develop an appropriate audit strategy. It can also help the auditor identify suggestions for improvement to the client.

Audit Risk and Materiality

5.104 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU 312), provides guidance on the auditor's consideration of audit risk and materiality when performing an audit. Audit risk, as described in the Statement, includes the risk that may be inherent in the nature of a transaction or balance, risk resulting from weaknesses in the internal control structure, and the risk that the auditor's tests may not detect misstatements resulting from the inherent and control risks. The System's Walk-Through Approach incorporates inherent and control risks in Section VII, "Evaluation of Risk of Potential Misstatements." Inherent risk is assumed to be maximum unless it is mitigated by internal control structure policies or procedures. Detection risk is minimized by the effectiveness of the auditing procedure followed.

Errors and Irregularities

5.105 SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU 316), requires auditors to assess the risk that errors and irregularities that have a material effect on the financial statements could occur, and to design and perform the audit to obtain reasonable assurance that such errors and irregularities will be detected during the audit. It also discusses the impact of errors and irregularities on the auditor's report, and the auditor's requirement to communicate errors and irregularities to the audit committee or its equivalent.

5.106 Paragraph 2 of SAS No. 53 (AU 316.02) defines errors as "*unintentional* misstatements or omissions of amounts or disclosures in financial statements." In paragraph 3 (AU 316.03), irregularities are defined as "*intentional* misstatements or omissions of amounts or disclosures in financial statements." Because irregularities are intentional (and, as a result, may involve forgery or collusion), they are usually more difficult to detect than errors.

5.107 Because the auditor's opinion is based on the concept of reasonable assurance, auditors cannot guarantee that financial statements are free from material misstatements due to errors and irregularities. However, they must exercise due care in planning, performing, and evaluating the results of the audit and must apply the appropriate level of professional skepticism to achieve reasonable assurance that the material errors and irregularities will be detected.

5.108 Auditors should assess the risk that errors and irregularities may cause the financial statements to be materially misstated. This risk assessment is part of audit planning and is either heightened or mitigated by the auditor's understanding of the internal control structure. Based on this assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that could have a material effect on the financial statements.

◆

5.109 SAS No. 53, paragraph 10 (AU 316.10) cites a number of management, operating, industry, and engagement characteristics that might cause the auditor to believe that there is an increased risk that material errors and irregularities could occur. Some of these characteristics are listed below:

- Management's operating and financing decisions are dominated by a single person.
- Management places undue emphasis on meeting earnings projections.
- The entity's profitability relative to its industry is inadequate.
- The entity operates in a declining industry with many business failures.
- Many contentious or difficult accounting issues are present.
- Significant and unusual related-party transactions or balances are present.

5.110 Completing or updating the Client Acceptance and Continuance Form (Chapter 3, section 3.400), the Small Business System's Walk-Through Documentation Form, and the Audit Planning Memorandum (Chapter 7, section 7.603) provide a basis for assessing the risk that material errors and irregularities could occur.

5.111 Design of the Audit. The auditor's judgment about the risk of material errors and irregularities should influence the design of the audit. For example, if the auditor concludes that there is a significant risk that material errors and irregularities could occur in an audit engagement, he or she must design an appropriate audit strategy to mitigate that risk. This strategy might involve placing more experienced staff on the engagement, increasing supervision and review of assistants' work, testing more items, performing procedures at year end rather than at interim dates, and modifying the nature of auditing procedures to obtain more reliable evidential matter.

5.112 Evaluating the Audit Test Results. Auditors are accustomed to evaluating the financial statement impact of differences between the client's accounting records and the auditor's findings. This evaluation is emphasized in SAS No. 53 because irregularities have implications beyond their direct monetary effects.

5.113 SAS No. 53 requires that when the auditor concludes that a potential audit adjustment related to an irregularity is not material to the financial statements, he or she should refer the matter to at least one level of management above those involved in the irregularity, and should be satisfied that the irregularity has no implications on other aspects of the audit. An example of an irregularity that would generally not be material to the financial statements is a misappropriation of petty cash.

Practice Tip:

If an irregularity is discovered, it should be brought to the attention of the engagement partner before it is discussed with the client.

5.114 If the auditor believes that the irregularity is or could be material to the financial statements, he or she should—

1. Consider the implications for other aspects of the audit.
2. Discuss the matter and the approach to further investigation with an appropriate level of management at least one level above those involved.
3. Attempt to obtain sufficient competent evidential matter to determine whether, in fact, material irregularities exist and, if so, their effect.
4. If appropriate, suggest that the client consult with legal counsel on matters concerning questions of law.

5.115 Effect of Irregularities on the Auditor's Report. If financial statements affected by a material irregularity are not revised, the auditor should express either a qualified or adverse opinion, explaining all substantive reasons for the opinion. If the auditor is unable to perform necessary auditing procedures related to the irregularity, or if the auditor is unable to reach a conclusion about the financial statement effect of the irregularity, he or she should issue a disclaimer of opinion, or a qualified opinion due to a scope limitation. If the client refuses to accept a modified auditor's opinion due to an irregularity, the auditor should withdraw from the audit.

5.116 In any event, the auditor should ensure that matters involving errors and irregularities are communicated to the audit committee or its equivalent.

Illegal Acts

5.117 SAS No. 54, *Illegal Acts by Clients* (AU 317), prescribes the nature and extent of consideration an auditor should give to the possibility that the client has committed illegal acts, and also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

5.118 Paragraph 2 of SAS No. 54 (AU 317.02) defines illegal acts as "violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity." Determining whether an act is illegal is normally beyond the auditor's professional competence, and would generally be based on the advice or on the findings of a court of law.

5.119 Of key importance to applying SAS No. 54 is an understanding of the difference between direct and indirect effects of laws and regulations. Direct-effect laws and regulations are those that affect financial statement line items. For example, federal tax laws directly affect the amounts of income tax expense and accruals reported in the financial statements. Indirect-effect laws and regulations are those that relate more to the entity's operations than to its financial statements, such as occupational safety and health, food and drug administration, equal employment, and anti-trust laws and regulations. While violations of these laws do not directly affect financial statement line items, they can result in monetary fines, penalties, and damages that could require adjustment to or disclosure in the financial statements. Understanding these two concepts is important because the auditor's responsibilities to detect and report direct-effect laws and regulations are different from the responsibilities to detect indirect-effect laws and regulations. Specifically, the auditor's responsibility to detect misstatements from illegal acts that have a

direct and material effect on the financial statements is governed by SAS No. 53 (as discussed in sections 5.105–.116). SAS No. 54 therefore applies to illegal acts related to indirect-effect laws and regulations (hereinafter called simply "illegal acts").

5.120 SAS No. 54 does not require the auditor to design tests to detect illegal acts; however, the auditor must be aware that illegal acts may have occurred and must perform certain audit procedures to confirm the existence of illegal acts if such specific evidence is discovered. The Statement indicates that the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. If information provided by management is insufficient to determine whether an illegal act has occurred, the auditor should—

- Consult with the client's attorneys or other specialists about the application of relevant laws and regulations to the circumstances, and the possible effects on the financial statements.
- Apply additional procedures, if necessary, to obtain further understanding of the nature of the act.

5.121 If the auditor concludes that an illegal act has occurred, he or she must consider the implications (both qualitative and quantitative) of the illegal act on the financial statements and the auditor's report. Improper accounting or inadequate disclosure of a material illegal act could result in a qualified or adverse opinion, disclosing all substantive reasons for the opinion. If the auditor is unable to obtain sufficient competent evidential matter about a possible illegal act, the auditor would generally disclaim an opinion on the financial statements. If the client refuses to accept a modified auditor's report in these situations, the auditor should consider withdrawing from the engagement, and should communicate the reasons for withdrawal to the audit committee or its equivalent, or to the board of directors or owners.

5.200 USING THE SMALL BUSINESS SYSTEM'S WALK-THROUGH DOCUMENTATION FORM

5.201 This Form is designed for use in small business audit engagements in which an all-substantive testing approach will be performed. Its purpose is to guide the auditor in obtaining an understanding of the client's accounting system, evaluating the risk of potential misstatements, gathering evidence that will corroborate other tests or information supporting the completeness assertion, designing the mix of evidence, and making suggestions that will assist the client in improving its accounting system.

5.202 The Form should be completed during engagement planning, prior to performing the analytical and tests of balances procedures. Significant weaknesses in the accounting system, that is, high risks of potential misstatements, should be compensated for by expanded analytical or tests of balances procedures.

5.203 On the other hand, low risks of potential misstatements and low overall engagement risk circumstances may permit slightly lower reliance on substantive tests. In such cases, the auditor may use some procedures that gather less reliable evidence, decrease sample sizes and, in some circumstances, perform certain tests of balances at interim dates.



5.204 The Form is comprised of the following eight sections:

- I. Industry Information
- II. Company Organization and Personnel
- III. Related Parties
- IV. Financing
- V. Accounting System Records and Procedures
- VI. Walk-Through Checklist
- VII. Evaluation of Risk of Potential Misstatements
- VIII. Preliminary Evidence Design Matrix

5.205 Completion of Sections I through V documents the auditor's understanding of the three elements of the control structure — control environment, control procedures, and accounting system — for a typical small business. Flowcharts and internal control questionnaires are generally not necessary in a small business engagement. These sections can be completed and updated by the client, and reviewed by engagement personnel.

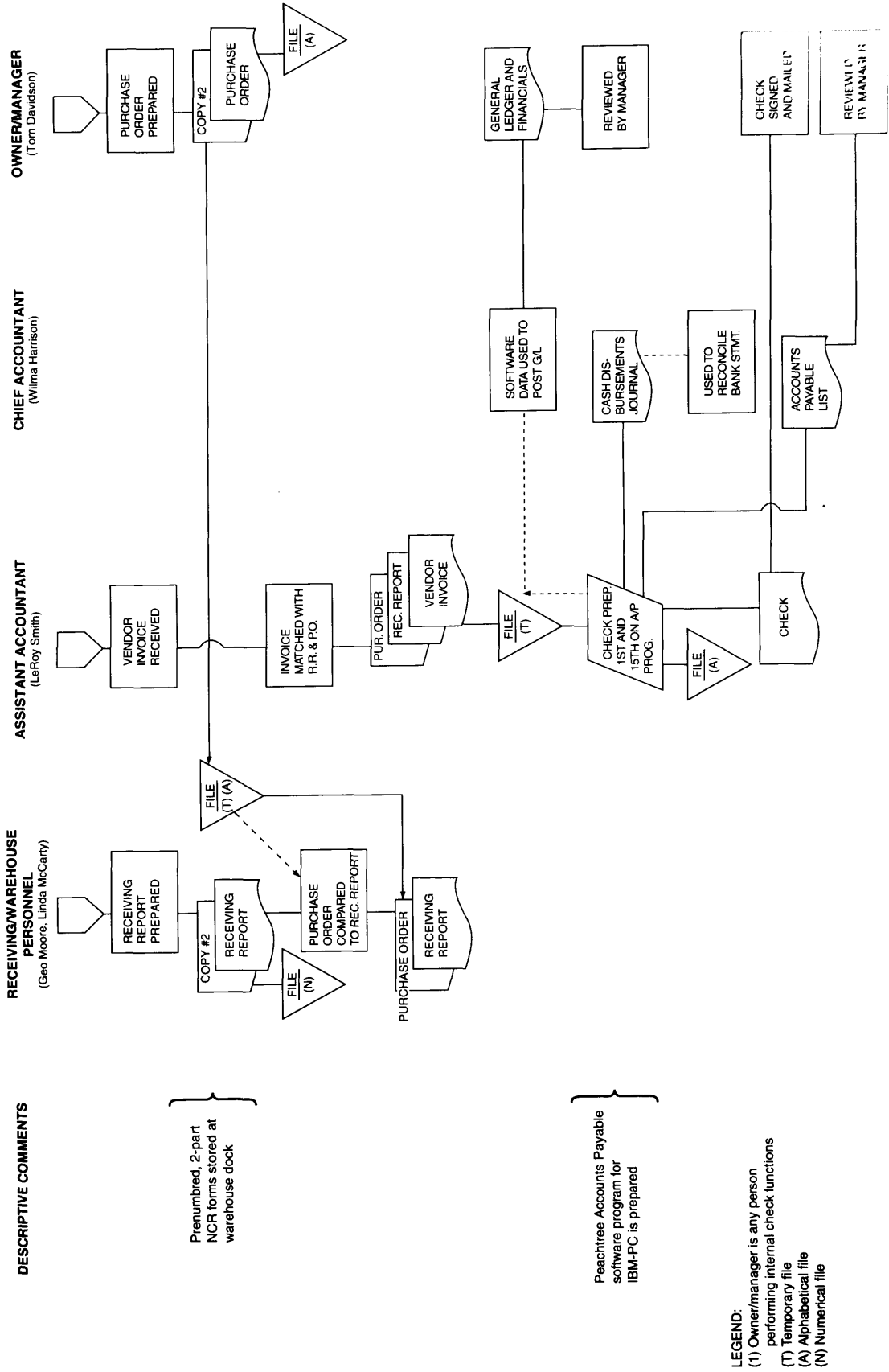
5.206 Section VI, the Walk-Through Checklist, supplements the auditor's understanding of the accounting system by requiring engagement personnel to walk a small number of transactions through the accounting system. This section is particularly helpful on new clients and for new firm personnel. It need not be performed every year, especially if the client's accounting system and personnel have not changed since the last engagement, and if control risk is assessed at the maximum.

5.207 As discussed in sections 5.105 through 5.121, SAS Nos. 53 and 54 require the auditor to consider the possibility that errors, irregularities, and illegal acts that have a material effect on the financial statements could occur and not be detected. These Statements require, among other things, that the auditor consider that possibility and design an appropriate audit strategy. Section VII, Evaluation of Risk of Potential Misstatements, helps the auditor evaluate the possibility that material errors, irregularities, and illegal acts could occur.

5.208 Section VIII, Preliminary Evidence Design Matrix, brings together the auditor's findings from the Client Acceptance and Continuance Form, the Audit Planning Memorandum, and Section VII above to design an appropriate audit strategy.

5.209 To facilitate completion of the walk-through, illustrative small business accounting system flowcharts have been included for reference. These flowcharts are intended to provide the auditor with an understanding that will aid completion of the Small Business System's Walk-Through Documentation Form. Flowcharting normally will not be performed in small business audits using the approach in this Manual.

5.300 Illustrative Small Business System's Flowchart Acquisitions and Payments Cycle



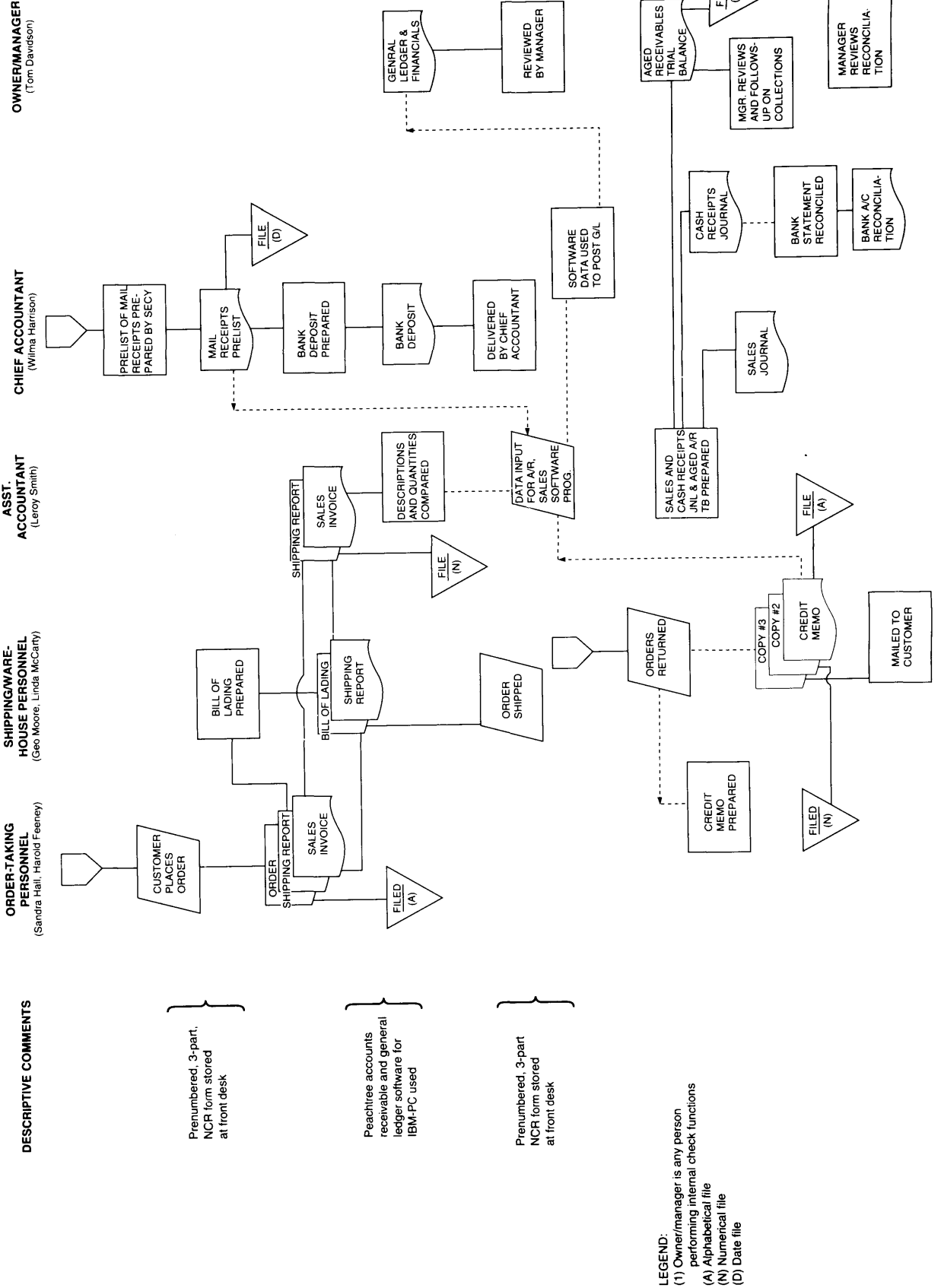
DESCRIPTIVE COMMENTS

Prenumbered, 2-part NCR forms stored at warehouse dock

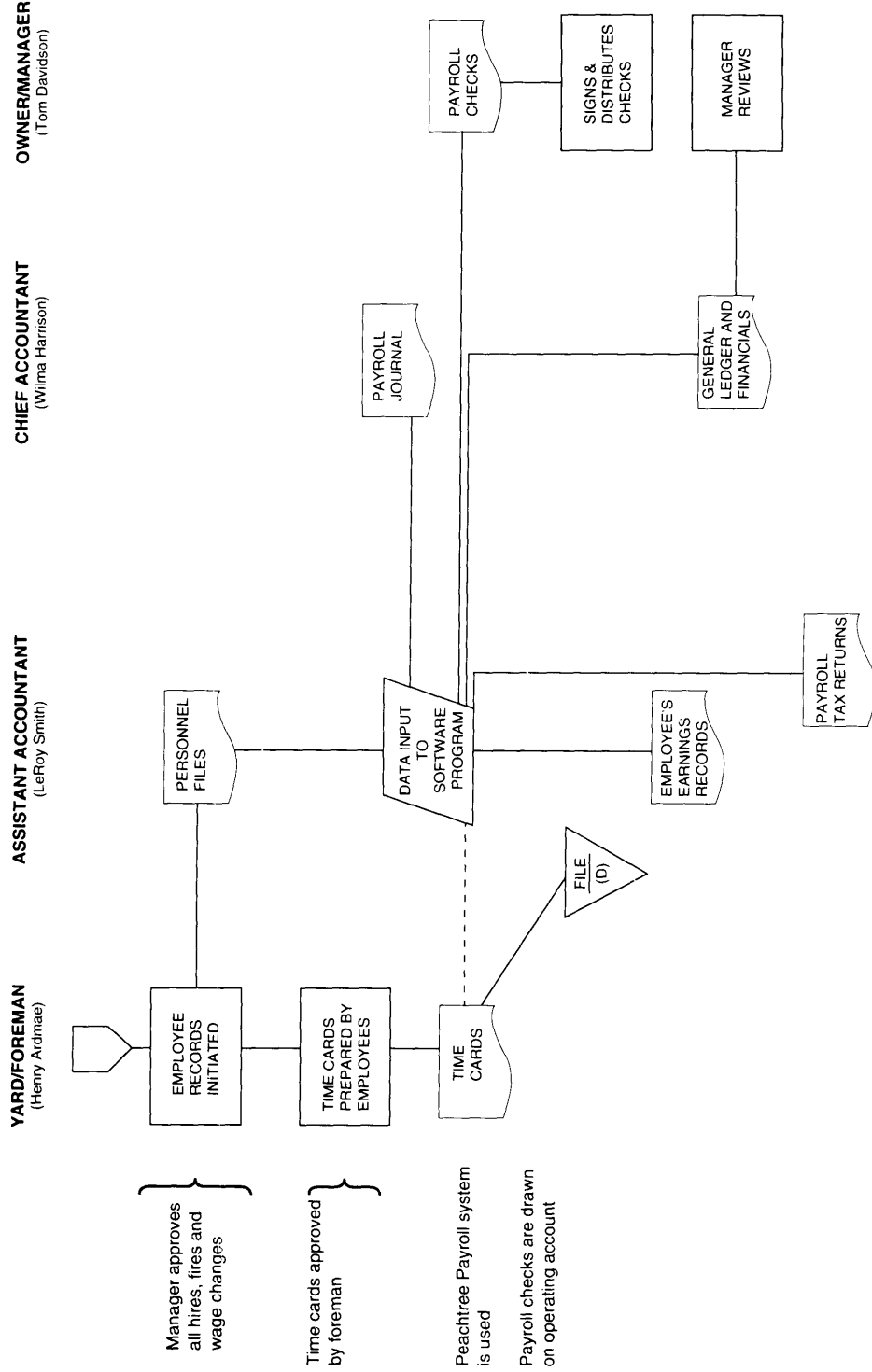
Peachtree Accounts Payable software program for IBM-PC is prepared

- LEGEND:
- (1) Owner/manager is any person performing internal check functions
 - (T) Temporary file
 - (A) Alphabetical file
 - (N) Numerical file

5.400 Illustrative Small Business System's Flowchart Sales and Collections Cycle



5.500 Illustrative Small Business System's Flowchart Payroll and Personnel Cycle



LEGEND:
 (1) Owner/manager is any person performing internal check functions
 (D) Date file

5.600

Small Business System's Walk-Through Documentation Form	
Client:	<u>ABC Company, Inc.</u>
Financial Statement Date:	<u>December 31, 19x4</u>

INSTRUCTIONS:

The Form should be prepared for all audit engagements in which an all-substantive testing approach will be used. If capable client personnel are available, sections I through V should be completed by such personnel and reviewed by the in-charge. Otherwise, the in-charge should complete these and the remaining sections. On a recurring engagement, the in-charge should update sections I through V by interviewing client personnel, but need not update the Walk-Through Checklist (section VI) if he or she (a) determines that there have been no changes to the client's system and (b) expects to assess control risk at the maximum. The in-charge should use the results of sections VI, VII, and VIII to modify the Small Business Analytical Procedures Program and the Small Business Tests of Balances Audit Program (TOB program). The Form should be reviewed by the engagement partner before any field work is begun.

All compensating analytical or tests of balances procedures should be cross-referenced to the Small Business Analytical Procedures Program or TOB program. Inapplicable or immaterial procedures may be marked "N/A" or "N/R."

I. INDUSTRY INFORMATION

A. Describe major divisions and lines of products or services.

Manufacturer of precast burial vaults
and manholes

B. What basis of accounting is used (GAAP, cash, tax, etc.)?

GAAP

C. Describe any significant or unusual accounting policies.

None

**Small Business System's Walk-Through Documentation Form
(Continued)**

II. COMPANY ORGANIZATION AND PERSONNEL

A. Identify and describe the responsibilities and experience of officers and accounting personnel.

<u>Name</u>	<u>Responsibilities</u>	<u>Experience</u>
Keith Rogers	Mgr - Customer Svc.	20 years
Nancy Oliver	Sales Manager	2 years
William O'Shea	Office Manager	5 years
Mary Jones	Clerk	5 years

III. RELATED PARTIES

A. Describe any affiliated company relationships.

ABC Transfers working capital to Open Space Big Mountain, buys manholes from ABC at ABC's cost.

B. Describe any relationships with major customers or vendors.

City of Rocky Top buys 20% of ABC's manholes and 10% of its vaults.

IV. FINANCING

A. Obtain copies of agreements for permanent file.

B. Describe major sources of short- and long-term financing.

1st Rocky Top - \$50,000 line of credit
Equipment is leased

C. Describe stock option, compensation, or repurchase plans.

Keith Jones' compensation is based on pre-tax profits

**Small Business System's Walk-Through Documentation Form
(Continued)**

- D. Describe any convertible debt features, compensating balance requirements, or restrictive debt covenants.

None

V. ACCOUNTING SYSTEM RECORDS AND PROCEDURES

A. Accounting System Records

Describe method of processing records (manual, write-it-once, microcomputer, service bureau, etc.).

Cash receipts journal: hand-written

Cash disbursements journal: hand-written

Sales journal: hand-written

Purchases journal: hand-written

Payroll journal and records: Peachtree Software

Subsidiary ledgers:

Accounts receivable: Peachtree Software

Accounts payable: none

Inventory: none

Fixed assets: Peachtree Software

Insurance: none

Other (describe):

General ledger maintained on Peachtree

B. Transaction Cycle Records

Describe the documents included in the major transaction cycles (number of parts, prenumbering, method of filing, etc.).

**Small Business System's Walk-Through Documentation Form
(Continued)**

Sales and Collections Cycle:

Customer order form: Copy of invoice used; filed by customer

Shipping report: copy of invoice used; matched and filed with invoice

Sales invoice: 3-part prenumbered form; filed by date shipped

Credit memo: same as sales invoice

Cash receipts prelist: none

Remittance advices: none

Deposit slips: 2 part: one part used for A/R posting, one filed by date

Other (describe): _____

Acquisitions and Payments Cycle:

Purchase order form: none

Receiving report: none

Vendor invoice: held in write basket until paid; then filed by vendor

Bank checks: 2-part, nonnegotiable copy filed w/ invoice

Other (describe): _____

Payroll and Personnel Cycle:

Employee personnel records and files (describe): Client phones and sends W-4s to firm where records are prepared.

Time cards: Computed manually; filed by pay period

Other (describe): _____

**Small Business System's Walk-Through Documentation Form
(Continued)**

C. Accounting System

Describe accounting system procedures by major transaction cycle.

Sales and Collections Cycle

Authorization

1. How is the sales transaction authorized? Customer places order by phone or in person
2. What document or record is used to evidence authorization? Invoice prepared by Nancy or Mary
3. Which personnel are involved with authorizing the sale and what are their responsibilities? Nancy, William, and Mary

Initiation

1. How is the sales transaction initiated? Copy of invoice given to yard foreman
2. What document or record is used to evidence initiation? (What is the point of sale?)
Copy of invoice in yard foreman's authorization to ship. After recording ship date, invoice returned to office.
3. Which personnel are involved with initiating a sale and what are their responsibilities?
Nancy, William, or Mary
4. How are cash collections received? Mail or over-the-counter
5. What documents are used to evidence cash collections? Invoice stamped "paid" for over-the-counter. Deposit slip for mail receipts.
6. Which personnel are involved with cash collections and what are their responsibilities?
William or Mary

**Small Business System's Walk-Through Documentation Form
(Continued)**

7. Who makes bank deposits and how often are they made? William
8. How are credits to customers' accounts initiated? from entries on deposit slips
9. What documents are used to evidence credits to customers' accounts? copy of invoice marked "Credit"
10. Which personnel are involved with initiating credits to customers' accounts and what are their responsibilities? William authorizes Nancy or Mary to prepare credit but doesn't sign copy of credit invoice

Recording

1. How are sales transactions recorded? by hand from invoices
2. Describe the source journal used to record sales transactions. hand written cash receipts and sales journal
3. Which personnel record transactions in the sales source journal and how often are entries prepared? William - monthly
4. How are cash receipts transactions recorded? manually by William
5. Describe the source journals used to record cash collections. same as sales journal
6. Which personnel record transactions in the cash collections source journal and how often are entries prepared? William - usually monthly

**Small Business System's Walk-Through Documentation Form
(Continued)**

Safeguarding and Accountability

1. How are sales and collections and accounts receivable balances summarized for individual customers? Client maintains AR records from sales invoices and copies of deposit slips
2. Which personnel are involved with the summarization of sales and collections and what are their responsibilities? William and Mary prepare input. Posted by CPA firm.
3. How often are customers' statements mailed? Monthly - William reviews before mailing.
4. How are sales and collections transactions posted to the general ledger and how often is it done? CPA firm - monthly
5. Which personnel reconcile general ledger accounts receivable balances with summaries of balances for individual customers and how often is it done? CPA firm - monthly
6. How often are receivables aged and reviewed by the owner or manager? Aged monthly and reviewed by William

Acquisitions and Payments Cycle

Authorization

1. How are purchases transactions authorized? Keith instructs William or Mary to order
2. What document or record is used to evidence purchases authorization? Keith "de's" invoice by signing
3. Which personnel can authorize purchases? Keith or Nancy

**Small Business System's Walk-Through Documentation Form
(Continued)**

Initiation

1. How are purchases transactions initiated? phone call
2. What document or record is used to evidence purchases initiation? (Which first evidences liability?) Vendor invoice signed by yard foreman when received
3. Which personnel are involved with initiating purchases and what are their responsibilities? Nancy controls purchasing functions
4. Who prepares checks, how many are prepared monthly, and how often are they prepared? William / 300 mo. / prepared weekly
5. Who signs checks and what documents are reviewed at the time of signing? Keith signs reverse vendor invoice signed by yard foreman
6. What procedures prevent duplicate payments? Keith initials invoice at time of check signing

Recording

1. How are purchases transactions recorded? from check copy by William
2. Describe the source journal used to record purchases transactions. Cash disbursements journal - manual
3. Which personnel record transactions in the purchases source journal and how often are entries prepared? William - throughout the month
4. Describe the source journal used to record disbursements. Same as purchases journal

**Small Business System's Walk-Through Documentation Form
(Continued)**

5. Which personnel record transactions in the disbursements source journal and how often are entries prepared? Same as #3
- _____
- _____

Safeguarding and Accountability

1. How are purchases and disbursements summarized by vendor? APs are summarized at month-end.
- _____
2. Which personnel are involved in the summarization and what are their responsibilities? William prepares at month-end.
- _____
3. How are purchases and payments posted to the general ledger and how often is it done? CPA firm posts monthly from cash disbursements journal.
- _____
4. Which personnel reconcile general ledger accounts payable balances with the summarization of purchases and disbursements by vendor? No reconciliation - CPA firm posts from William's list.
- _____
5. What kinds of documents or records are maintained to control inventory items? None - Nancy orders when piles of sand, cement, rock, etc get low.
- _____
6. Which personnel are involved with the inventory recordkeeping? N/A
- _____
7. Which personnel have physical access to inventories? all employees
- _____
8. How often are physical counts of inventories made? annually - @ year-end by Nancy
- _____
9. What kinds of fixed asset records are maintained and who has responsibility for maintaining them? CPA firm maintains detailed depreciation records
- _____
- _____

**Small Business System's Walk-Through Documentation Form
(Continued)**

Payroll and Personnel Cycle

Authorization

1. How are employees hired and fired? Keith and yard foreman control changes - telephoned to CPA firm
2. What documents or records are used to evidence hiring or firing? W-4 for hires; none for fires
3. Which personnel are involved with hiring and firing and what are their responsibilities? Keith and yard foreman

Initiation

1. How are hours worked by employees accounted for? manually-prepared time cards signed by employee and yard foreman.
2. What document or record is used to evidence hours worked? time cards
3. Which personnel approve hours worked and how is the approval evidenced? Yard foreman's signature on time card
4. How are rates of pay, withholdings, and deductions established or changed? Keith instructs William to call CPA firm
5. Which personnel are involved in payroll computations and what are their responsibilities? CPA firm on Peachtree Software

Recording

1. How are payroll transactions recorded? CPA firm using Peachtree software

**Small Business System's Walk-Through Documentation Form
(Continued)**

2. Describe the source journal used to record payroll transactions. payroll
transactions register
3. Which personnel record transactions in the source journal and how often are entries prepared? CPA firm for weekly payroll

Safeguarding and Accountability

1. What kinds of employee payroll records are maintained? software calculates
earnings and payroll tax records and reports
2. Which personnel are involved in preparing these records? time cards sent
to CPA firm by Nancy or William
3. How often are paychecks distributed by the owner or manager? William
distributes weekly.

General

1. How is the general ledger posted and balanced and how often is it done? CPA firm
monthly
2. Which personnel post and balance the general ledger? CPA firm
3. Which personnel prepare and post adjusting journal entries? CPA firm
4. Which personnel are involved with the bank statement reconciliation and how often is it reconciled? William prepares monthly

**Small Business System's Walk-Through Documentation Form
(Continued)**

5. How often are financial statements prepared and what information do they contain?
full sets of financial statements prepared monthly
6. What internal checks are performed by the owner or manager that have not been mentioned above?
Owner reviews monthly F/S.
7. What hazard and fidelity insurance is carried by the company?
Hazard appears adequate; no fidelity coverage.
8. Does the owner or manager adequately segregate personal transactions from the business? (Describe any such personal transactions recorded in the business records.)
Yes

Control Environment

1. Describe the organization of management, accounting, and operations personnel below or attach an organization chart.
See attached organization chart
2. Describe the owner's attitudes and practices that may affect the risk of misstatements or irregularities in the financial statements. Consider such factors as deteriorating operations creating a need for working capital, financial statement ratios influencing lenders' decisions, motivation of owner to reduce income taxes, and owner's history of taking unnecessary business risks.
Nothing unusual. Operations are profitable. Normal small business need for working capital.
3. In the case of an absentee owner, describe the manager's compensation method and whether it is reasonable.
Manager's compensation based on 10% of pretax earnings. Not unreasonable.
4. Describe the owner's awareness of the importance of having a good accounting system, performing owner/manager controls, and understanding and using related financial information.
Owner's understanding of financial information is weak. Does not emphasize importance of accounting info. and controls.

**Small Business System's Walk-Through Documentation Form
(Continued)**

5. List the accounting personnel, their positions, and length of employment; describe briefly their education and experience; and evaluate their job performance. William, office manager - 5yrs; Mary clerk, 5yrs. Both are knowledgeable and effective.

19 24 19 ____ 19 ____ 19 ____ 19 ____

Prepared or updated by:

Client

SS _____ _____ _____ _____

In-charge

JK _____ _____ _____ _____

**Small Business System's Walk-Through Documentation Form
(Continued)**

VI. WALK-THROUGH CHECKLIST

Walk-through procedures must be documented on a working paper, in a memorandum, or on copies of documents selected from the client's records. The working paper reference should be entered in each column as each step is completed. Any procedures not applicable should be marked "N/A."

<u>Procedure</u>	<u>Transactions</u>					
	<u>Sales</u>	<u>Coll.</u>	<u>Acq.</u>	<u>Paymt.</u>	<u>Payroll</u>	<u>Personnel</u>
1. For each type of transaction, select at least two documents from the population.	<u>WP10-1</u>	<u>WPB-1</u>	<u>WPC-1</u>	<u>WPBB-1</u>	<u>WP40-1</u>	<u>WP40-11</u>
2. Obtain copies of the documents, prepare a flowchart or working paper, or write a memo to record the documents inspected and the procedures performed.	<u>WP10-2</u>	<u>WPB-2</u>	<u>WPC-2</u>	<u>WPBB-2</u>	<u>WP40-2</u>	<u>WP40-12</u>
3. Based on the client's system description above, walk through each transaction by performing the following:						
a. Examine the documents to determine that the authorization and initiation procedures are performed and evidenced.	<u>WP10-3</u>	<u>WPB-3</u>	<u>WPC-3</u>	<u>WPBB-3</u>	<u>WP40-3</u>	<u>WP40-13</u>
b. Verify the clerical and mathematical accuracy of data on the document.	<u>WP10-4</u>	<u>WPB-4</u>	<u>WPC-4</u>	<u>WPBB-4</u>	<u>WP40-4</u>	<u>WP40-14</u>
c. Trace the documents to a source journal entry and compare them to the recorded information.	<u>WP10-5</u>	<u>WPB-5</u>	<u>WPC-5</u>	<u>WPBB-5</u>	<u>WP40-5</u>	<u>WP40-15</u>
d. Test foot the primary column in the source journal for an appropriate period and trace the total to the general ledger.	<u>WP10-6</u>	<u>WPB-6</u>	<u>WPC-6</u>	<u>WPBB-6</u>	<u>WP40-6</u>	<u>WP40-16</u>

**Small Business System's Walk-Through Documentation Form
(Continued)**

<u>Procedure</u>	<u>Transactions</u>					
	<u>Sales</u>	<u>Coll.</u>	<u>Acq.</u>	<u>Paymt.</u>	<u>Payroll</u>	<u>Personnel</u>
e. Select a representative bank statement and inspect evidence of reconciliation and review procedures.	<u>WP10-7</u>	<u>WPB-7</u>	<u>WPC-7</u>	<u>WP20-7</u>	<u>WP40-7</u>	<u>WP40-17</u>
f. Scan the general journal for the year and obtain explanations for unusual entries.	<u>WP10-8</u>	<u>WPB-8</u>	<u>WPC-8</u>	<u>WPBB-8</u>	<u>WP40-8</u>	<u>WP40-18</u>
g. Inspect evidence of the periodic balancing of the general ledger.	<u>WP10-9</u>	<u>WPB-9</u>	<u>WPC-9</u>	<u>WPBB-9</u>	<u>WP40-9</u>	<u>WP40-19</u>
h. Read the most recent internally prepared financial statements or trial balance and investigate any unusual matters.	<u>WP10-10</u>	<u>WPB-10</u>	<u>WPC-10</u>	<u>WPBB-10</u>	<u>WP40-10</u>	<u>WP40-20</u>

**Small Business System's Walk-Through Documentation Form
(Continued)**

VII. EVALUATION OF RISK OF POTENTIAL MISSTATEMENTS

Describe weaknesses in the accounting system's procedures, material and unusual account balances resulting from the transactions, prior years' adjustments or exposure areas related to the transactions, complex applications of accounting principles, related-party transactions, client-imposed scope limitations, an initial engagement, or other special considerations that may indicate high risks of potential misstatements that could materially affect the entity's financial statements.

Sales and Collections Cycle

Nancy and Mary have complete control over sales and collections. Although sales invoices are prenumbered, and voided ones are destroyed, there is no accounting of used invoices. A sale could be made and cash collected without entry into accounting records.

Evaluation of risk of potential misstatements (circle): High Low

Description of analytical or tests of balances procedures to compensate for high risks (cross-reference to TOB program):

Analysis of gross margin by product, monthly sales comparison and analysis of major customer activity should be performed. A/R confirmations should cover at least 70% of balance. Major customers should be asked to confirm A/R and sales activity for the year.

Acquisitions and Payments Cycle

Even though Keith controls payments, analytical procedures should be performed, as well as tests of balances.

**Small Business System's Walk-Through Documentation Form
(Continued)**

Evaluation of risk of potential misstatements (circle): High Low

Description of analytical or tests of balances procedures to compensate for high risks (cross- reference to TOB program):

Payroll and Personnel Cycle

Although Keith controls these transactions, analytical procedures and tests of balances should disclose any major problems. Also, payroll is consistent throughout the year and variance is unusual.

Evaluation of risk of potential misstatements (circle): High Low

Description of analytical or tests of balances procedures to compensate for high risks (cross-reference to TOB program):

VIII. PRELIMINARY EVIDENCE DESIGN MATRIX

Instructions:

A high risk of potential misstatements, or high overall engagement risk, normally will require application of the most reliable procedures to large sample sizes at or near the balance-sheet date. A low risk of potential misstatements, and low overall engagement risk, will permit using less reliable procedures, selecting smaller sample sizes, and performing certain procedures at an interim date. The following matrix is based on the evaluation of overall engagement risk from the Client Acceptance and Continuance Form, on the evaluation of risk of potential misstatements above, and on the Audit Planning Memorandum.

◆

**Small Business System's Walk-Through Documentation Form
(Continued)**

The "Reliance on TOBs" column will be used to—

1. Select the sections of the TOB program applicable to the client.
2. Guide the modification of the nature, extent, and timing of the standard TOB program procedures.

Transaction Cycles Section:

The "Overall Risk" and "Risk of Misstatements" columns in the Transaction Cycles Section should be designated as either high, low, or not applicable (N/A). Indicate "N/A" when the account balance is not material or when the client has no such account. The "Reliance on TOBs" column will be the higher of the designations in the two Risk columns. In other words, for reliance on tests of balances to be low, both Risk columns must contain a "low" designation. A low reliance designation will permit the use of less reliable procedures, such as negative confirmations, smaller sample sizes, and certain testing at an interim date. *A low reliance designation does not indicate, however, the degree of reductions in substantive testing that could be achieved through high, extensive reliance on tests of controls.*

General Section

Most of the evidence necessary to verify financial statement assertions for the account classifications listed under the General Section is obtained from tests of balances and will generally be unaffected by risk—that is, reliance will usually be high because of the nature of the procedures typically performed. The "Reliance on TOBs" column for these classifications should be designated as either high or N/A. Since reliance on analytical procedures will normally be high on all small business audits, no column has been provided for such procedures.

**Small Business System's Walk-Through Documentation Form
(Continued)**

<u>Audit Area</u>	<u>Overall Risk¹</u>	<u>Risk of Misstatements²</u>	<u>Reliance on TOBs</u>	<u>TOB Program³</u>
TRANSACTION CYCLES SECTION				
Revenues and Collections				
1. Trade accounts receivable	<u>L</u>	<u>H</u>	<u>H</u>	II
2. Sales	<u>L</u>	<u>H</u>	<u>H</u>	XIX
Acquisitions and Payments				
3. Inventories and costs of sales	<u>L</u>	<u>H</u>	<u>H</u>	VI, VII, XX, XXII
4. Fixed assets	<u>L</u>	<u>L</u>	<u>L</u>	X
5. Accounts payable	<u>L</u>	<u>L</u>	<u>L</u>	XIII
6. Expense accounts	<u>L</u>	<u>L</u>	<u>L</u>	XXI, XXII
Payroll and Personnel				
7. Payroll accounts	<u>L</u>	<u>L</u>	<u>L</u>	XXIII
GENERAL SECTION				
1. Cash			<u>H</u>	I
2. Other accounts receivable			<u>H</u>	III
3. Notes receivable			<u>H</u>	IV
4. Allowance for doubtful accounts			<u>H</u>	V
5. Marketable securities			<u>H</u>	VIII
6. Prepaid expenses			<u>H</u>	IX
7. Investments and other assets			<u>N/A</u>	XI
8. Deferred charges and intangibles			<u>N/A</u>	XII
9. Accrued expenses, income taxes and other liabilities			<u>H</u>	XIV
10. Notes payable and long-term debt			<u>N/A</u>	XV
11. Stockholders' equity			<u>H</u>	XVII
12. Other revenues			<u>H</u>	XXI

¹ From the evaluation of overall engagement risk in the Client Acceptance and Continuance Form, and the Audit Planning Memorandum.

² From the evaluation of risk of potential misstatements in section VII above.

³ TOB program sections standard to each engagement include sections XVI, XVIII, and XXIV.

**Small Business System's Walk-Through Documentation Form
(Continued)**

Audit Area	Overall Risk ¹	Risk of Misstatements ²	Reliance on TOBs	TOB Program ³
13. Specialized industry areas:				

14. Post all reportable conditions to the Summary of Matters for Communication.

Prepared by: Sam Sartain Date: 10/21/24
 (In-charge)

Reviewed by: Sara Miller Date: 11/4/24
 (Engagement Partner)

¹ From the evaluation of overall engagement risk in the Client Acceptance and Continuance Form, and the Audit Planning Memorandum.

² From the evaluation or risk of potential misstatements in Section VII above.

³ TOB program sections standard to each engagement include sections XVI, XVIII, and XXIV.

CHAPTER 6
INTERNAL CONTROL STRUCTURE REPORTABLE CONDITIONS

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CHAPTER 6

INTERNAL CONTROL STRUCTURE REPORTABLE CONDITIONS

6.000 PURPOSE

6.001 The purpose of the Internal Control Structure Reportable Conditions Form (section 6.300) is to provide a means to collect information about material and immaterial weaknesses in the internal control structure, and other matters, for communication to management.

6.100 AUTHORITATIVE PRONOUNCEMENTS

6.101 Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU 325), requires that any deficiencies noted in the design or operation of an entity's control structure must be communicated to the entity's audit committee, management, or others within the client organization.

6.102 Often, as a benefit to their clients, auditors communicate matters that are not related to the internal control structure, such as operational and administrative deficiencies. SAS No. 60 allows auditors to include such comments in a report on internal control structure related matters, and although not required, the authors recommend that such comments be separately identified and segregated from reportable conditions. For a more in depth discussion of SAS No. 60 communications, see sections 2.309–2.316.

Material Weaknesses

6.103 SAS No. 60 [AU 325.15] defines a material weakness as:

a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

6.104 In other words, material weaknesses are reportable conditions that are of such a magnitude that it is likely that an error or irregularity having a material effect on the financial statements could occur and not be detected by the client's internal control structure.

6.105 The auditor is not required to separately identify material weaknesses, or to segregate them from other reportable conditions; however, in certain situations (such as when there are a large number of material weaknesses or when the client has requested that material weaknesses be identified), it may be preferable to do so.



6.200 USING THE INTERNAL CONTROL STRUCTURE REPORTABLE CONDITIONS FORM

6.201 Internal control structure related and other matters should be recorded on the Internal Control Structure Reportable Conditions Form under the in-charge's supervision as they come to the attention of engagement personnel. The situation, problem, and recommendation for each matter should be written as they would be presented in a letter to management. Doing so not only provides training opportunities for engagement personnel, but facilitates preparation of the written or oral communication.

6.202 If this Form is used as the basis for an oral communication of internal control structure related matters, the communication should be documented in an accompanying memorandum that records managements' reactions to recommendations and its plans for corrective actions, if any.

6.203 A written communication indicating that no reportable conditions were noted should not be issued in accordance with SAS No. 60.

6.300

Internal Control Structure Reportable Conditions Form
Client: _____
Financial Statement Date: _____

INSTRUCTIONS:

This Form should be completed by the in-charge, or supervised staff, and reviewed by the engagement partner for all audit engagements. The information should be used to complete the required communication of internal control structure related and other matters.

The Small Business System's Walk-Through Documentation Form or any internal control flowcharts or narratives are the primary sources for identifying reportable conditions. Reportable conditions represent deficiencies in the design or operation of the internal control structure. A reportable condition may be of such a magnitude that it is considered a material weakness. These items should be identified as such on the Form. Other operational or administrative suggestions that are not considered reportable conditions may also be included on this Form.

The Form is designed to include the documentation source of the conditions, the audit areas affected by the conditions, and a format for writing comments.

Prepared by: _____ Date: _____
(In-charge)

Reviewed by: _____ Date: _____
(Engagement Partner)

6.300

REPORTABLE CONDITIONS

Documentation —Source—	Audit Areas Affected by —Condition—	<u>Situation</u>	<u>Problem</u>	<u>Recommendation</u>	Discussed with	<u>Disposition</u>
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CHAPTER 7

PLANNING

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CHAPTER 7

PLANNING

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CHAPTER 7

PLANNING

7.000 PURPOSE

7.001 This chapter includes the documentation necessary to plan an audit of a small business engagement.

7.002 In section 7.300 is a Materiality Computation Form that should be used to determine materiality for planning and sampling purposes.

7.003 Section 7.400 includes an explanation of sampling as well as forms to be used by the auditor to document the selection and evaluation of the sampling used.

7.004 Section 7.500 explains the Audit Planning Memorandum that should be prepared on all engagements to document the auditor's planning decisions.

7.100 AUTHORITATIVE PRONOUNCEMENTS

7.101 Professional standards include many general and specific planning requirements. The two basic requirements to plan engagements are—

- (1) The third General Standard of Rule 201 of the AICPA *Code of Professional Conduct* (ET 201.01) states that a member shall "adequately plan and supervise the performance of professional services."
- (2) The first standard of field work, as stated in AICPA Statement on Auditing Standards (SAS) No. 1, section 150, *Generally Accepted Auditing Standards* (AU 150.02), requires that "The work is to be adequately planned and assistants, if any, are to be properly supervised."

7.102 Audit planning is also affected by the following SASs.

1. SAS No. 22, *Planning and Supervision*
2. SAS No. 31, *Evidential Matter*
3. SAS No. 39, *Audit Sampling*
4. SAS No. 41, *Working Papers*
5. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*
6. SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements*
7. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*

8. SAS No. 54, *Illegal Acts by Clients*
9. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*
10. SAS No. 56, *Analytical Procedures*
11. SAS No. 57, *Auditing Accounting Estimates*
12. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
13. SAS No. 67, *The Confirmation Process*
14. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*
15. SAS No. 73, *Using the Work of a Specialist*

7.103 The Audit Planning Memorandum (section 7.503) provides documentation to comply with the planning requirements included in these pronouncements.

7.200 MATERIALITY

7.201 The overall materiality limit is the maximum amount of unadjusted misstatements, known and unknown, an auditor is willing to accept in the financial statements taken as a whole. The overall materiality limit is commonly determined in practice as follows.

<u>Materiality Base — Greater of Total Assets or Total Revenues</u>		<u>Percentage of the base</u>
<u>Over</u>	<u>But Not Over</u>	
\$ 0	\$ 30,000	6.0%
30,000	100,000	\$ 1,800 + 5.0% in excess of \$ 30,000
100,000	300,000	5,300 + 3.0% in excess of 100,000
300,000	1,000,000	11,300 + 2.0% in excess of 300,000
1,000,000	3,000,000	25,300 + 1.5% in excess of 1,000,000
3,000,000	10,000,000	55,300 + 1.0% in excess of 3,000,000
10,000,000	30,000,000	125,300 + 0.5% in excess of 10,000,000
30,000,000	100,000,000	225,300 + 0.25% in excess of 30,000,000
100,000,000	300,000,000	400,300 + 0.20% in excess of 100,000,000
Over 300,000,000		800,300 + 0.15% in excess of 300,000,000

7.202 The overall materiality limit can be determined by completing the Materiality Computation Form (section 7.300). The overall materiality limit should be the largest of the amounts determined as explained above and on the form. Materiality limits for major financial statement classifications, as determined using the above guidelines, may be entered on the Summary of Possible Journal Entries Form (Chapter 10, section 10.500) at the engagement partner's option. The materiality limits for the major classifications will be used primarily to measure the effects of known but unadjusted misstatements.

Subscribers to the 1994 Edition of this Manual will notice that the bases and percentages for computing materiality on the Materiality Computation Form in section 7.300 have been changed. This was done to better reflect current practice, and will result in lower materiality thresholds.

7.203 Tolerable misstatement amounts are the maximum amounts of unadjusted misstatements, known and unknown, the auditor is willing to accept. The sum of tolerable misstatements for all accounts will theoretically equal the overall materiality limit. Determining tolerable misstatements is usually only necessary for classical variables sampling applications.



Materiality Computation Form
(Continued)

II. Basic Allowance for Unknown Misstatement Computation

For nonstatistical sampling applications, the basic allowance can be used in place of the tolerable misstatement amount. If used in the table approach or model approach, it should also be considered when comparing total actual, projected, and estimated misstatements to the overall materiality limit.

Overall materiality limit from above	\$ _____
Less estimated known misstatement from sampling and non-sampling tests (1/3 of overall materiality limit)	_____
Basic allowance for unknown misstatement (tolerable misstatements)	\$ <u> </u>

III. Individually Significant Items — Computation of Lower Limit

The lower limit for individually significant items will usually be set at 1/3 of the basic allowance. Individually significant items may also be determined judgmentally for each sampling application. The rationale for such judgmentally determined limits should be explained at the bottom of the page.

Lower limit for individually significant items	\$ <u> </u>
--	----------------------

Rationale for lower limit:

This uniform lower limit will normally be used for determining individually significant items to derive sampling populations, and for determining sampling populations and account balances that are not material that can be excluded from testing.

If different lower limits are used for certain accounts, or for such procedures as sales and purchases cutoff tests and searches for unrecorded liabilities, the reasons for their use should be documented below:

Prepared by: _____ Date: _____
(In-charge)

Reviewed by: _____ Date: _____
(Engagement Partner)

7.400 SAMPLING DECISIONS

Audit Procedure Study and Changes to "Sampling Decisions"

7.401 As this Manual goes to print, the Auditing Standards Division of the AICPA is developing an Audit Procedure Study (APS) to replace the AICPA Audit and Accounting Guide, *Audit Sampling*. The APS is expected to be issued by the fourth quarter of 1995.¹

7.402 The guidance contained in this section is consistent with the guidance in the Audit and Accounting Guide except that the "assurance factors" used in the Model Approach (see section 7.436) conform with those used in the draft APS. The authors believe that these factors better reflect current practice.

7.403 This section has been revised to make it easier to comply with the requirements of SAS No. 39, *Audit Sampling*. To simplify our coverage of audit sampling for substantive tests, the Table Approach to nonstatistical sampling found in previous editions of this Manual has been removed from this edition of the Manual because the approach is in substance equivalent to the Model Approach. Practitioners who wish to use the Table Approach should refer to the AICPA Audit and Accounting Guide, *Audit Sampling*. In this regard, the following forms have been deleted:

- Sampling Decision Working Paper
- Sample Size Selection and Evaluation Form

7.404 The requirements for audit sampling are included in SAS No. 39, *Audit Sampling* (AU 350), and the AICPA Audit and Accounting Guide, *Audit Sampling* (AAG-SAM).

7.405 According to SAS No. 39, *Audit Sampling* (AU 350), sampling occurs when the auditor tests less than 100% of a population to make some conclusion about the population. SAS No. 39 applies to tests of controls when such tests are performed and to tests of balances when sampling populations are material. The extent to which sampling is used in an audit depends on the size of the client and the nature of the client's internal control structure. If the sampling populations are small, it is usually more efficient to audit individually significant items and obtain audit assurance about the remaining balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client's internal control structure increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

¹ The new APS may be obtained by calling the AICPA's Order Department at 1-800-862-4272.

Audit Sampling for Tests of Controls

7.406 SAS No. 39 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This Manual provides guidance for both approaches. Regardless of whether nonstatistical or statistical sampling is being used, audit sampling for tests of controls involves the following steps:

- 1. Determine the objective of the test** — The objective of a test of control is to determine whether a particular internal control policy or procedure is being applied as prescribed. Audit sampling for tests of controls is generally appropriate when application of the internal control policy procedure leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant internal control policy or procedure was applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling.
- 2. Define the deviation conditions** — A deviation condition is a situation that indicates that the policy or procedure was not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (e.g., the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Adequate performance of a policy or procedure consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed procedure requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped "Paid." The auditor believes that the existence of an invoice and a receiving report, both stamped "Paid," is necessary to indicate adequate performance of the procedure for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as "a disbursement not supported by an invoice and a receiving report that have been stamped 'Paid.'"
- 3. Define the population** — The population selected must be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of an internal control procedure designed to determine if all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.

For samples to be representative of the period under audit, the population generally should include all transactions processed during the period. However, sometimes the results of tests performed at an interim date may be sufficient to generalize about the population for the entire period. In determining whether interim tests are sufficient, the auditor should consider the results of the tests, responses to inquiries concerning the remaining period, the length of the remaining period, the nature and amounts of the transactions or balances involved, and related evidence obtained from the tests of balances. If a control policy or procedure has been changed during the year, the auditor will often decide that it is efficient to only test the new policy or procedure.

For sample results to be reliable, the sample must be selected from the complete population. Completeness of the population can be determined by either physical or numerical control. Normally, the auditor can establish the completeness of the population by inspecting the documents to see that it appears that they have all been accounted for.

- ◆
4. **Determine the method of selecting the sample** — Any sample that is selected should be representative of the population and all items should have an opportunity to be selected. Random-number selection should generally be used when statistical sampling is being applied. When nonstatistical sampling is applied, random-number sampling, systematic sampling, and haphazard sampling are methods that might be used to obtain a representative sample. Methods of selecting samples are discussed beginning at section 7.443.
 5. **Determine the sample size** — Sample sizes for tests of controls are affected by (1) the risk of assessing control risk too low, (2) the tolerable deviation rate, (3) the expected population deviation rate, and (4) any effects of small population sizes.

Guidance for determining sample size when performing nonstatistical sampling begins with section 7.409. A description of statistical sampling begins with section 7.412.

6. **Perform the sampling plan** — Once the sample has been selected, the auditor should examine each item for evidence of performance of the internal control policy or procedure. If the auditor selects an item that is unused (e.g., a voided document), the auditor should select another item, at random. However, the auditor should make sure that the item really represents an unused item. If the document is valid, but cannot be found, the item should be treated as a deviation in evaluating the sample results.
7. **Evaluate the sample results** — Guidance for evaluating nonstatistical sampling results begins with section 7.410 and guidance for evaluating statistical sampling results begins with section 7.413.
8. **Document the sampling procedure** — The audit working papers should document the following matters:
 - The objectives of the test.
 - A description of the deviation conditions.
 - The acceptable risk of assessing control risk too low.
 - The tolerable deviation rate.
 - The expected deviation rate.
 - The sample results, including the disposition of any deviations found.
 - The effect of the results on the auditors assessed level of control risk.

7.407 Factors Affecting Sample Sizes for Tests of Controls. Sample sizes for tests of controls are affected by the following factors:

1. *Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk that the sample supports a lower level of control risk than is in fact the case. Decreasing the risk of assessing control risk too low will increase the sample size.



2. *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. As the expected population deviation rate increases, the sample size will increase.
3. *Tolerable deviation rate.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure that the auditor is willing to accept without increasing the assessed level of control risk. Higher tolerable deviation rates will permit smaller sample sizes.
4. *Population size.* Populations over 500 items have little or no effect on sample size. For populations under 500 in size, the auditor may slightly reduce the size of the sample.

7.408 The effects of these factors may be summarized as follows:

<u>Factor</u>	<u>Effect on Sample Size</u>
Acceptable risk of assessing control risk too low — increase (decrease)	Smaller (larger)
Tolerable deviation rate — increase (decrease)	Smaller (larger)
Expected population deviation rate — increase (decrease)	Larger (smaller)
Population size	Populations less than 500 items should be adjusted to slightly smaller sample sizes

7.409 Sample Sizes Using Nonstatistical Sampling. Nonstatistical sample sizes for tests of controls may be determined using the sample size selection tables in section 7.410, or they may be selected on a purely judgmental basis. Sample sizes should be entered directly on the appropriate Tests of Controls Program. For each method of selection, the auditor should document consideration of the relevant factors. For example, the rationale for selecting tests of controls sample sizes of 30 from the first table in section 7.410 for an internal control system that is classified as a System B may be—

1. Control risk will be assessed at a moderate level, and
2. The expected population deviation rate is at or near zero.

7.410 The following tables should be used for a nonstatistical approach to determine sample sizes for tests of controls:

**CONTROLS TESTING NONSTATISTICAL
SAMPLE SIZE SELECTION TABLE**

<u>Assessed Level of Control Risk</u>	<u>Sample Size</u>
Maximum	0
Slightly below the maximum	15
Moderate	30
Low	40

The numbers in the table were determined using a risk of assessing control risk too low of 10% and an expected population deviation rate of 0%. When deviations are expected or found in a sample, the following table may be used to determine the sample size or evaluate the sample results:

<u>Deviations (Expected or Actual)</u>	<u>Assessment of Control Risk</u>		
	<u>Slightly Below Maximum</u>	<u>Moderate</u>	<u>Low</u>
0	15	30	40
1	25	50	65
2	34	67	90
3	43	85	115

7.411 In evaluating the results of the sample, the auditor should consider the number of deviations found and the nature of the deviations. If the auditor uses the first table in section 7.410 to determine sample size, the discovery of one or more deviations will require the auditor to reassess the planned level of control risk. In these cases, the second table in section 7.410 may be used to evaluate the assessed level of control risk that is supported by the sample results. When looking at the nature of the deviations, the auditor is concerned with the following questions:

- Was the cause of the deviation an error or does it indicate an intentional violation of the control?
- Are there implications for other audit areas?

7.412 Sample Sizes Using Statistical Sampling. The appropriate statistical method for tests of controls is attributes sampling, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling results may be used to estimate the frequency of deviations from performance of an internal control policy or procedure.

7.413 Applying attributes sampling involves performing the following steps:

1. **Decide on the attributes to test.** The Tests of Controls Program may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.
2. **Define the population from which the sample items should be selected.** The auditor should make sure that the population is appropriate for the audit objective as described in section 7.406.
3. **Specify the following factors:**
 - *Acceptable Risk of assessing control risk too low.* The risk of assessing control risk too low is the risk the sample supports a lower level of control risk than is the case. Since sample evidence represents the only evidence typically obtained about the operating effectiveness of a particular control, the risk of assessing control risk too low is usually set at 5% or 10%.
 - *Tolerable deviation risk.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure the auditor is willing to accept without increasing the assessed level of control risk. Higher assessments of control risk will permit higher tolerable deviation rates as shown in the following table:

<u>Planned Assessed Level of Control Risk</u>	<u>Tolerable Rate</u>
Low	2% - 7%
Moderate	6% - 12%
Slightly below the maximum	11% - 20%
Maximum	Omit test

- *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. The auditor's expectations may be based on prior years' experience with the client, or experience with similar clients. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.
4. **Determine the appropriate size sample.** Sample sizes are found in the tables in sections 7.414 through 7.415. The table in section 7.414 is designed for a risk of assessing control risk too low of 5%, and the table in section 7.415 is designed for a 10% risk of assessing control risk too low. With the tolerable deviation rate and the expected deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.
 5. **Randomly select the sample from the population.** The section beginning at section 7.443 describes the methods that may be used to select a random sample.

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6. **Perform the audit procedures to identify deviations in the sample.**
 7. **Calculate the statistical results.** Using the tables in sections 7.416 through 7.417 the appropriate risk of assessing control risk too low, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.
 8. **Reassess the level of control risk.** If the actual deviation rate in the sample is higher than that specified in determining the sample, the sample results will not support the auditor's planned assessed level of control risk. In these situations, the auditor should increase the assessed level of control risk. The auditor should also consider the causes of the deviations found, and whether they have implications for other audit areas.
 9. **Document the Sampling Procedures.** The audit working papers should document the matters set forth in section 7.406 (Item 8).

7.414

**Statistical Sample Sizes for Testing Controls
Five Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)**

Expected Population Deviation Rate	Tolerable Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

*Sample Size is too large to be cost effective for most audit applications.

Derived from AICPA Audit and Accounting Guide, Audit Sampling.

NOTE: This table assumes a large population.

7.415

Statistical Sample Sizes for Testing Controls
Ten Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Expected Population Deviation Rate	Tolerable Rate										
	<u>2%</u>	<u>3%</u>	<u>4%</u>	<u>5%</u>	<u>6%</u>	<u>7%</u>	<u>8%</u>	<u>9%</u>	<u>10%</u>	<u>15%</u>	<u>20%</u>
0.00%	144(0)	76(0)	57(0)	45(0)	38(0)	32(0)	28(0)	25(0)	22(0)	15(0)	11(0)
.25	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.50	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.75	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00	*	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25	*	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50	*	*	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75	*	*	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00	*	*	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25	*	*	*	132(3)	88(2)	75(2)	65(2)	42(1)	38(1)	25(1)	18(1)
2.50	*	*	*	158(4)	110(3)	75(2)	65(2)	58(2)	38(1)	25(1)	18(1)
2.75	*	*	*	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00	*	*	*	*	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25	*	*	*	*	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50	*	*	*	*	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75	*	*	*	*	*	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00	*	*	*	*	*	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00	*	*	*	*	*	*	160(8)	115(6)	78(4)	34(2)	18(1)
6.00	*	*	*	*	*	*	*	182(11)	116(7)	43(3)	25(2)
7.00	*	*	*	*	*	*	*	*	199(14)	52(4)	25(2)

*Sample Size is too large to be cost effective for most audit applications.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table assumes a large population.



7.416

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Five Percent Risk of Assessing Control Risk Too Low

Sample Size	Actual Number of Deviations Found										
	<u>0</u>	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
25	11.3	17.6	*	*	*	*	*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*	*	*	*
40	7.3	11.4	15.0	18.8	*	*	*	*	*	*	*
45	6.5	10.2	5.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	5.5	15.9	18.2	*	*	*	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*	*	*	*
65	4.6	7.1	9.4	11.5	5.6	15.5	17.4	19.3	*	*	*
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	*	*
75	4.0	6.2	8.2	10.1	11.8	5.6	15.2	16.9	18.5	20.0	*
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	*
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	5.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

*Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.

7.417

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Ten Percent Risk of Assessing Control Risk Too Low

Actual Number of Deviations Found

<u>Sample Size</u>	<u>0</u>	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
20	10.9	18.1	*	*	*	*	*	*	*	*	*
25	8.8	14.7	19.9	*	*	*	*	*	*	*	*
30	7.4	12.4	16.8	*	*	*	*	*	*	*	*
35	6.4	10.7	14.5	18.1	*	*	*	*	*	*	*
40	5.6	9.4	12.8	16.0	19.0	*	*	*	*	*	*
45	5.0	8.4	11.4	14.3	17.0	19.7	*	*	*	*	*
50	4.6	7.6	10.3	12.9	15.4	17.8	*	*	*	*	*
55	4.1	6.9	9.4	11.8	14.1	16.3	18.4	*	*	*	*
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	*	*	*
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	17.9	19.6	*
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.6
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.6
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	15.9	15.0
120	2.0	3.3	4.4	5.5	6.6	7.6	8.7	9.7	10.7	11.6	12.6
160	1.5	2.5	3.3	4.2	5.0	5.8	6.5	7.3	8.0	8.8	9.5
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6

*Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.



Audit Sampling for Tests of Balances

7.418 In planning tests of balances, the auditor should decide on the most efficient approach to performing the tests. For some recorded populations, instead of sampling, it may be more efficient to examine individually significant items comprising a majority, or near majority, of the recorded population. Audit assurance about the remaining balance may then be obtained by (1) performing analytical procedures, or (2) concluding that the risk of material misstatement of the remaining balance is low. For example, confirmation of 50% to 80% of the dollar amount of accounts receivable may be necessary when risk is high; 40% to 60% may be sufficient when risk is low.

7.419 Obviously, when the remaining balance, after auditing the individually significant items, is immaterial, no testing of the remaining balance is necessary.

7.420 The decision to sample, or not to sample, should be documented in the Audit Planning Memorandum (section 7.503).

7.421 Selecting all individually significant items is not considered a sampling application. Items such as large receivables are usually examined individually. Procedures used for examining such items should ordinarily be the most reliable under the circumstances, such as positive confirmation requests.

7.422 When planning a sampling application for tests of balances, the in-charge should consider the financial statement assertions and audit objectives and their relationship to populations selected. For example, understatements cannot be detected by sampling recorded amounts; instead, units from populations of all existing transactions must be selected.

7.423 The following is an approach to nonstatistical sampling for tests of balances.

1. Determine the sampling population by identifying and deducting the individually significant items.
2. Determine the sample size by considering the following factors:
 - The amount of tolerable misstatement.
 - The assessed level of inherent and control risk for the assertions being tested.
 - The risk that other substantive procedures (e.g., analytical procedures) will fail to detect a material misstatement.
 - Variations within the population.
3. Select the sample.
4. Perform the test procedure.

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5. Evaluate the results.
 - Project the misstatement.
 - Consider sampling risk.
 - Consider qualitative aspects of the test results.
 6. Document the sample procedure when using the Model Approach described in sections 7.431–7.442, the Model Approach Working Paper — Tests of Balances Sampling (see section 7.452) and the Audit Sampling Evaluation Form — Tests of Balances Sampling (see section 7.451) may be used for this purpose.

7.424 Sample selection methods should produce representative samples and may include random selection, systematic selection, or haphazard selection methods. Care should be taken to avoid bias, however, when a haphazard selection method is used. Section 7.443 describes these sample selection methods.

7.425 Determine the Sample Size for Tests of Balances. Sample sizes for tests of balances are affected by the following factors:

- *Tolerable misstatement.* As the amount of tolerable misstatement increases, the sample size decreases. Conversely, larger sample sizes are required to compensate for a smaller amount of tolerable misstatement. The tolerable misstatement for a sampling application may be taken from the Materiality Computation Form in section 7.300.
- *Assessed level of inherent and control risk.* As the combined level of inherent and control risk increases, the sample size increases.
- *The risk that other substantive procedures will fail to detect a material misstatement.* As the risk that other substantive procedures will fail to detect a material misstatement increases, the sample size increases. This risk is determined by considering the effectiveness of these procedures.
- *Variations within the population.* Sample sizes are smaller when the sampling population is stratified into homogeneous groups. Larger sample sizes are usually required to obtain a representative sample from sampling populations with high variations.

7.426 Illustration No. 7-1 summarizes the impact of the factors above on sample size planning.

ILLUSTRATION NO. 7-1

FACTORS INFLUENCING SAMPLE SIZES FOR
SUBSTANTIVE TESTS OF BALANCES

<u>Factor</u>	<u>Conditions Leading to:</u>	
	<u>Smaller Sample Size</u>	<u>Larger Sample Size</u>
a. Tolerable misstatement	Larger amount.	Smaller amount.
b. Assessed level of inherent and control risk.	Lower.	Higher.
c. Risk that other procedures will fail to detect a material misstatement.	Lower.	Higher.
d. Variation within the population.	Less variation.	More variation.

7.427 Nonstatistical Sampling Approaches. At the direction of the engagement partner, either of the following nonstatistical approaches can be used for selecting tests of balances sample sizes:

1. Judgmental method.
2. Model approach.

7.428 Judgmental Method. Sample sizes can be selected judgmentally after considering the influence of the factors described above. The in-charge should describe, in the Audit Planning Memorandum, the factors that influence the sample sizes selected for substantive tests of balances. The engagement partner should approve the planned sample sizes before the substantive tests of balances work is begun. See section 7.503 for an illustrative Audit Planning Memorandum.

7.429 Judgmentally selected samples are considered in terms of audit coverage of a total population. Large dollar coverage generally includes individually significant items, and units from the sampling population that cover more than 50% of the dollar amount of the total population.

7.430 The coverage of the total population will also be affected by the nature of the population and the degree of the engagement risks. For example, a large coverage of accounts receivable for confirmation in high-risk circumstances may be from 50% to 80% of the total dollar population. A large coverage for an

inventory price test in the same circumstances may only be 30% to 40% of total inventory because the risk of inventory price misstatement is generally less. In low-risk circumstances, a large coverage of accounts receivable may be 40% to 60%, a large inventory coverage may be 20% to 30%. These percentages are not presented as specific guidelines for decision making, but as illustrations of the factors influencing nonsampling decisions. Since the auditor's opinion is expressed on the financial statements taken as a whole, evidence should be designed to include tests of a majority of the dollars in the financial statements, but should also be, overall, the most efficient in the circumstances.

7.431 The Model Approach. The model approach is a nonstatistical sampling method that is based on Probability-Proportion-To-Size (PPS) Sampling. Because the approach is based on PPS theory, the overall materiality limit does not have to be allocated to each account to determine tolerable misstatements. Instead, the basic allowance for unknown misstatement, i.e., overall materiality limit minus estimates for unadjusted misstatement from nonsampling tests, expected projected misstatement from sampling tests and related allowances for imprecision, may be used in place of tolerable misstatement for each sampling application. An acceptable approach would be to use $66\frac{2}{3}\%$, or a smaller percentage, of the overall materiality limit for the basic allowance. (See the Materiality Computation Form in section 7.300.) Under PPS theory, the overall materiality limit does not have to be allocated to accounts because the financial statements may be viewed as one population and the basic allowance for unknown error applies to the financial statements taken as a whole. The basic allowance must also be considered, however, when measuring misstatements on the Summary of Possible Journal Entries Form (Chapter 10, section 10.500).

7.432 It is important to recognize that when sample sizes are selected nonstatistically based on some statistical theory such as PPS, it is assumed that the population will be stratified. A simple method of stratification is as follows:

- Determine the mean of the population to be sampled.
- Select $\frac{2}{3}$ of the sample items from those items equal to or greater than the mean.
- Select $\frac{1}{3}$ of the sample items from those items less than the mean.

7.433 If it is not practical to stratify the sampling population, the sample size should be increased by a factor of 20%, or multiplied by 1.2.

7.434 A more time consuming, yet more accurate method would, of course, be a PPS statistical selection method. For the sake of time, however, this statistical method ordinarily is not used. When populations are unusually large and engagement risks are high, however, a PPS statistical method may be appropriate. Guidance for PPS statistical sampling may be found in the AICPA Audit and Accounting Guide, *Audit Sampling*.

7.435 Developed from the model in the Audit Sampling Guide (paragraphs 4.57 to 4.60), the Model Approach follows:

$$\begin{array}{rcccl}
 \text{Sampling Population} & & \times & \text{Assurance} & = & \text{Preliminary} \\
 \text{Tolerable Misstatement} & & & \text{Factor} & & \text{Sample} \\
 & & & & & \text{Size} \\
 & & & & & \text{(units)} \\
 \\
 \text{Preliminary} & & \times & \text{Marginal} & = & \text{Adjusted} \\
 \text{Sample} & & & \text{Risk} & & \text{Sample} \\
 \text{Size} & & & \text{Factors} & & \text{Size} \\
 \text{(Units)} & & & \text{(1.2 to 1.5)} & & \text{(units)}
 \end{array}$$

7.436 The assurance factors, also based on PPS statistical theory, are as follows:

Assessment of inherent and control risk	Risk that other substantive procedures (e.g. analytical procedures) will fail to detect a material misstatement		
	<u>Maximum</u>	<u>Moderate</u>	<u>Low</u>
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

7.437 The steps to be taken in determining the sample size using the Model Approach Working Paper Tests of Balances Sampling Form (see section 7.450) are as follows:

A. Assess the combination of inherent and control risk:

1. **Maximum** — Control and inherent risk are assessed at the maximum for the particular assertions. No tests of controls are required to support this assessment.
2. **Slightly below the maximum** — Control and inherent risk are assessed at slightly below the maximum for the particular assertions. Minimal tests of controls are required for this assessment.
3. **Moderate** — Control and inherent risk are assessed at a moderate level for this particular assertion. Moderately effective tests of controls are required for this assessment.
4. **Low** — Control and inherent risk are assessed at a low level for the particular assertions. Very effective tests of controls are required for this assessment.

B. Determine the basic allowance for unknown misstatements (tolerable misstatement). This is related to preliminary estimates of materiality for the engagement.

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- C. Assess the risk that other substantive procedures (such as analytical procedures) designed to test the same assertions will fail to detect a material misstatement in a particular assertion as follows:
1. Maximum — No other substantive procedures are performed that are designed to test the same assertions.
 2. Moderate — Other substantive procedures to test the assertions are expected to be moderately effective in detecting material misstatements.
 3. Low — Other substantive procedures to test the assertions are expected to be highly effective in detecting material misstatements.
- D. Determine the population's recorded amount after deducting any items that will be audited 100% (all items that are more than 1/3 of tolerable misstatement).
- E. Use the appropriate assurance factor and the formula to determine the initial sample size.

7.438 Depending on the amount of the basic allowance for unknown misstatements, sample sizes computed with this model may approximate those sizes selected judgmentally. Because the model is based on a highly stratified approach, and this approach usually will include minimal or no stratification, the sample should be somewhat larger than the preliminary size if there are significant variations in the population. If stratification is necessary and is not practical, an acceptable approach would be to multiply the preliminary sample size by a marginal risk factor of 1.2 to compensate for the sampling risk associated with not stratifying. The marginal risk factor should *not* be used when the population is stratified or when stratification is not necessary.

7.439 Evaluating the Sample Results. The misstatement in the sample must be projected to the population. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement by the fraction of total dollars in the population to total dollars included in the sample. For example, if a \$1,000 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be \$10,000 ($\$1,000/.10$).

7.440 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if \$200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is \$2 ($\$200/100$). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 25,000 items) by the average difference of \$2 for each sample item. The estimate of misstatement in the population is \$50,000 ($25,000 \times \2).

7.441 If the projected misstatement is less than tolerable misstatement for the account balance, consideration must be given to the risk that actual misstatement exceeds the amount of tolerable misstatement. If the projected misstatement is less than 1/3 of tolerable misstatement, it is generally safe to conclude that sampling risk is sufficiently low. If it is greater than 1/3, consideration should be given to performing additional tests of the account.



7.442 The Audit Sample Evaluation Form — Tests of Balances (section 7.451) is designed to project the misstatement in the sample to the population, and to evaluate sampling risk. The form should be completed by the in-charge and reviewed by the engagement partner. Remember that any projected misstatement should be posted to the Summary of Possible Journal Entries Form.

Selecting Samples

7.443 SAS No. 39 permits random number selection, systematic selection with or without random starts and haphazard selection methods for nonstatistical sampling. Block sampling is not acceptable. A random number selection method should be used for statistical sampling.

7.444 Random-based selection methods can be applied using random number tables or computer or calculator programs. The Random Selection With a Random Table Form (see section 7.452) may be used to document sample size selections using a random number table.

7.445 To use a random number table:

1. Assign each element in the population a unique address that corresponds to the random number table.
2. Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
3. Place a pencil on a page to determine a random starting point.
4. Modify the population numbers to the smallest possible number of digits to reduce discards.

7.446 The procedure for using a program or calculator to generate random numbers varies with the programs. However, these techniques generally require the auditor to provide the smallest and largest item numbers, and the number of sample items needed.

7.447 Systematic sampling requires the calculation of an interval. An interval is determined by dividing the population size by the number of sample units desired. For example:

$$\begin{aligned}
 N &= \text{Sample Size} &&= 4,000 \\
 n &= \text{Desired Units} &&= 50 \\
 I &= \text{Interval} \\
 I &= \frac{N}{n} = \frac{4000}{50} &&= 80
 \end{aligned}$$

◆ **7.448** After selecting a random number within the interval as a starting point, each 80th unit would be selected. The Random Selection With a Systematic Sample Form in section 7.453 may be used to document systematic selection methods with random starts.

7.449 Haphazard sampling involves selecting items on a purely judgmental basis, without any bias towards the selection of particular items.

7.450

<p>Model Approach⁽¹⁾ Working Paper — Tests of Balances Sampling</p>
<p>Client: _____</p>
<p>Financial Statement Date: _____</p>

INSTRUCTIONS:

This Form should be completed by the in-charge during planning and approved by the engagement partner before field work is started.

1. Check the financial statement assertion(s) being tested:

- | | |
|-----------------------------------|----------------------------------|
| a. Existence and occurrence _____ | c. Completeness _____ |
| b. Rights and obligations _____ | d. Valuation or allocation _____ |

2. Description of sampling application: _____

3. Total recorded population for _____ \$ _____
 Less amount of individually significant items
 (Usually all items equal to or greater than 1/3
 of tolerable misstatement) (_____)
 Sample population \$ _____

4. Describe what will be considered to be a misstatement for testing purposes:

⁽¹⁾ The model approach generally will not be used for populations containing less than 500 units or large populations of small-dollar units.

Model Approach Working Paper — Tests of Balances Sampling

(Continued)

Assessment of inherent and control risk	Risk that other substantive procedures (such as analytical procedures) will fail to detect a material misstatement		
	Maximum	Moderate	Low
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

5. Calculate the initial sample size with the following formula:

$$\begin{array}{ccccccc}
 & \text{Basic Allowance} & & \text{Assurance} & & \text{Initial Sample} & \\
 \text{Sampling Population} & \text{(Tolerable Misstatement)} & & \text{Factor} & & \text{Size} & \\
 \$ \underline{\hspace{2cm}} & \div \$ \underline{\hspace{2cm}} & \times & \underline{\hspace{2cm}} & = & \underline{\hspace{2cm}} &
 \end{array}$$

6. Allocate the sample items:

	Population		Sample	
	Items	Dollars	Items	Dollars
a. Stratum 1—Items above the mean of the sampling population (select 2/3 of the sample items from this subpopulation)	___	\$ ___	___	\$ ___
b. Stratum 2—Items less than the mean of the sampling population (select 1/3 of the sample items from this subpopulation)	___	\$ ___	___	\$ ___
c. Total	___	\$ ___	___	\$ ___

Prepared by: _____ Date: _____
 (In-charge)

Reviewed by: _____ Date: _____
 (Engagement Partner)

7.451

<h2 style="margin: 0;">Audit Sample Evaluation Form — Tests of Balances Sampling</h2>
<p>Client: _____</p>
<p>Financial Statement Date: _____</p>

1. Project the misstatement (use only one column if the sample population was not stratified):

	Stratum 1	Stratum 2
a. Misstatement in the sample	\$ _____	\$ _____
b. Dollar value of the sample	\$ _____	\$ _____
c. Dollar value of the strata	\$ _____	\$ _____
d. Projected misstatement in the sample stratum (c. ÷ b. × a.)	\$ _____	\$ _____
e. Total projected misstatement in the sample population (d.1 + d.2)	\$ _____	

2. Evaluate sample risk:

a. Misstatements found in the group audited 100%	\$ _____
b. Projected misstatement in the sample population (1.e.)	\$ _____
c. Total projected and known misstatement (2.a. + 2.b.)	\$ _____
d. Amount of above misstatement corrected	\$ _____
e. Remaining known and projected misstatement (2.c.-2.d.)	\$ _____ *
f. Tolerable misstatement for the account (From the Model Approach Working Paper—Tests of Balances)	\$ _____
g. Is the remaining known and projected misstatement (e.) less than 1/3 of the amount of tolerable misstatement (f)?	Yes ____ No ____

If the answer to g is "No," sampling risk may be unacceptably high and additional testing should be considered.

*This amount should be posted to the Summary of Possible Journal Entries Form (chapter 10, section 10.500).

7.452

Random Selection With a Random Table Form
Client: _____
Financial Statement Date: _____

INSTRUCTIONS:

To use the random selection method with a random number table:

- Assign each element of the population a unique address that corresponds to the random number table.
- Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
- Place a pencil on a page to determine a random starting point.
- Modify the population numbers to the smallest possible number of digits to reduce discards.
- Pure random sampling should be applied to the entire population; stratified random sampling would separate the population according to some characteristic such as size of elements or features of the underlying transaction. This form should be used to document random selection with a random table or calculator. If a computer is used, a copy of the computer printout should be retained as documentation.

POPULATION DESCRIPTION

1. Type of document designated as the sampling unit. _____
 - a. Largest document number plus 1 _____
 - b. Smallest document number _____
 - c. Population size _____
2. Nature of the sampling unit if not a document _____
3. Description of the population if No. 2 is applicable (including population size and numbering of population). _____

RANDOM NUMBER TABLE

Name of table. _____

Page(s) used. _____

Correspondence between the table
and sampling units (normally
document number). _____

Number of digits used. _____

Starting point in table. _____

First usable sample number. _____

Last usable sample number. _____

Stopping point in table. _____

Number of sample items selected. _____

Modifications to reduce discards. _____

Prepared by: _____
(In-charge)

Date: _____

Reviewed by: _____
(Engagement Partner)

Date: _____

7.453

Random Selection With a Systematic Sample Form
Client: _____
Financial Statement Date: _____

INSTRUCTIONS:

This form is used to document systematic selection methods with random starts.

POPULATION DESCRIPTION

1. Type of document designated as the sampling unit. _____
 - a. Largest document number plus 1 _____
 - b. Smallest document number _____
 - c. Population size _____
2. Nature of the sampling unit if not a document. _____
3. Description of the population if No. 2 is applicable (including population size and numbering of population). _____

Population Size _____ = initial interval

Sample Size _____

Initial interval × number of desired starts =
adjusted interval

Rounded interval.

Random number(s) from the table.

First sample item(s).

Last sample item(s).

Prepared by: _____ Date: _____
(In-charge)

Reviewed by: _____ Date: _____
(Engagement Partner)

7.500 USING THE AUDIT PLANNING MEMORANDUM

7.501 The Audit Planning Memorandum is the culmination of the planning process and should be prepared for all small business audit engagements. It is critical to achieving both engagement quality and profitability. The Memorandum should be prepared by the in-charge and approved by the engagement partner before engagement personnel begin field work. It can be prepared using the form in the documentation package, or in a handwritten or typed narrative as illustrated in section 7.503.

7.502 The Audit Planning Memorandum is comprised of Section I, Engagement Administration, and Section II, Technical Audit Planning Decisions. A few words about section subheadings follow:

I. A. Presentation of Engagement Letter

The engagement letter is a primary tool for obtaining client understanding of the firm's and the client's responsibilities. A good understanding before the engagement begins will prevent misunderstandings later. To gain a good understanding, the engagement partner should deliver the letter and discuss its contents with the client's audit committee or persons of equivalent authority, or with management.

I. B. Use of Client Assistance or Paraprofessionals

The schedule attached to the Client Acceptance and Continuance Form (see Chapter 3, section 3.400) lists possible areas of client assistance. Client assistance should be used to the maximum extent possible on every engagement. When client personnel are unavailable, the use of firm para-professionals to perform any necessary accounting services and clerical work in connection with the engagement should be considered.

I. C. Work Space and Equipment

The in-charge has responsibility for arranging adequate work space before the field work begins. Poor lighting, lack of adequate heat or air conditioning, desks or tables that are too small, or work locations that are not near client accounting personnel are examples of situations that hinder the efficient completion of an engagement.

I. D. Assignment of Staff

A basic element of a good quality control system is assigning personnel to engagements and tasks that are commensurate with their capabilities. Assigning the right people to engagements also helps complete the engagements in the minimum amount of time.

Whenever possible, the prior year's engagement personnel should be reassigned and rotated to new positions each year. When reassignment is not possible, an attempt should be made to assign new staff with experience in the client's business or industry. When inexperienced personnel, or personnel unfamiliar with the client's business or industry, are assigned to an engagement, the in-charge or engagement partner is responsible for providing appropriate training.

I. E. Target Dates

Setting target dates during planning is the first step to achieving timely engagement completion. These target dates should also become the input to the firm's staff scheduling system.

I. F. Use of Specialists

The use of outside specialists should be considered when performing any auditing procedures in areas outside the firm's expertise. Such areas may include actuarial computations for pension funds, questions of law, observations of inventories of products or materials, or audits designed using clients' computer systems.

I. G. Use of Audit Software

Audit software should be used to the maximum extent practical on all engagements. This section should list the specific, planned applications for engagement partner approval.

I. H. Audit Budget

The audit budget should be prepared, at least tentatively, prior to the beginning of field work. The budget should be based on circumstances, not on fees. The budget documents should be summarized in this section for discussion with the engagement partner.

I. I. Special Considerations

This section is provided to document any significant engagement administration circumstances or problems not covered above.

II. A.-F. Technical Audit Planning Decisions

Each section should present the results of the decisions, as well as the rationale, or judgments, behind them. Detailed computations or explanations should be either included or incorporated by reference to other working papers or forms. Section II.E. must include documentation about the assessed level of control risk if the assessed level of control risk is below the maximum.

II. G. Planning Analytical Procedures

Analytical procedures used in planning the audit should focus on enhancing the auditor's understanding of the client's operations, transactions, and events that have occurred since the last audit, and on identifying areas that may present significant audit risks. Such procedures range from reviewing changes from the prior year to the current year's working trial balances, to more extensive analyses using quarterly financial information.



II. H. Other Considerations

Special risks of misstatements, irregularities, or illegal acts, or any other accounting or auditing problems discovered during planning, should be discussed in this section. The situation, its possible impact on the financial statements, and the planned modification of auditing procedures should be detailed for consideration and approval by the engagement partner.

7.503

Audit Planning Memorandum

Client: XYZ Company, Inc.Financial Statement Date: December 31, 19XX

INSTRUCTIONS:

This memorandum should be completed for all audit engagements by the in-charge and reviewed by the engagement partner before engagement personnel begin field work.

I. ENGAGEMENT ADMINISTRATION

A. Presentation of Engagement Letter

On September 1, 19X, Monty Manager presented our engagement letter to Samantha Ryan, CEO. He discussed the nature of our audit services and the client's responsibility to provide an adjusted trial balance and working paper schedules by January 21, 19Y.

Before preparing the letter, he reaffirmed that our firm is independent with regard to XYZ and that there is no reason for us not to continue to service this client.

B. Use of Client Assistance and/or Paraprofessionals

Client will prepare schedules listed on an attachment to engagement letter. Chief Accountant was given standard working papers and copies of last year's papers on September 15, 19X. Client will provide one clerical person during field work for our use to pull invoices, type correspondence, etc. A firm paraprofessional will be used to foot client schedules and records, to perform clerical work, to send accounts receivable confirmations and other correspondence, and to perform certain limited account analysis work.

C. Proper Work Space

The client's main conference room has been booked from October 1 to October 5 and from January 21 to February 14, 19Y for our use. The client will provide three calculators. We will bring our microcomputer and printer.

D. Assignment of Staff

Mary Smith and John Jones, assistants, have been assigned for the dates of field work in C above. Both worked on the engagement last year.



Audit Planning Memorandum
(Continued)

E. Target Dates

Start of interim field work	October 1, 19X
Start of year-end field work	January 21, 19Y
Audit report	March 1, 19Y
Management letter	March 1, 19Y
Tax returns	March 15, 19Y
Other	

F. Use of Specialists

We have engaged Hank Brown of Best Wood Products Co. to assist us in observation of the building materials inventory. Our firm's EDP consultant, Gene Osborne, will prepare a detailed EDP Questionnaire and assist us in designing our tests.

G. Use of Audit Software

Our audit software package will be used to record the trial balance, post adjustments and generate financial statements. Analytical procedures will be performed using software. The time budget and control documents will be prepared with software.

H. Audit Budget

Based on the prior year's actual time and preliminary discussions of current circumstances with client personnel, the budget is computed as follows:

	<u>Hours</u>	<u>Rate</u>	<u>Dollars</u>
Partner	48	240	\$ 4,800
In-Charge	160	50	8,000
Assistants	120	30	3,600
Total	328		\$16,400

I. Other Special Considerations

Audit Planning Memorandum
(Continued)

II. TECHNICAL AUDIT PLANNING DECISIONS

A. Overall Engagement Risk (See Workpaper F)

Use of financial statements:

The financial statements of XYZ Company, Inc. will be submitted to FN Bank to obtain additional working capital for the production of a new line of hand tools.

While the Company has not experienced losses during the last four years, profits after taxes have been less than 3% of net sales when the industry average was 4%. The low margin, in part, has been the result of extensive retooling for the new line introduced last year. A new major contract with a national retailer could amount to increased revenues next year of nearly 40%. The Company is currently in a negative working capital position of .5 to 1.0 and the debt to equity ratio is 3.8 to 1.0. This creates potential going-concern problems.

Integrity of management:

No information has come to our attention that would cast doubt on the integrity of management.

Auditability of the entity:

There is no reason to believe that the Company's accounting system will not provide sufficient evidence to support the recorded transactions.

Business environment:

No information has come to our attention to indicate any imminent adverse effects that may result from the Company's business environment.

Because there are potential going-concern problems, and because the purpose of our report is to help obtain financing to correct those problems, overall engagement risk is evaluated as high. The effect of the higher risk will be to reduce the lower limit for individually significant items and to reduce the acceptable levels of risk of overreliance and risk of incorrect acceptance for sampling applications.

B. Understanding of Internal Control Structure

We have completed the Small Business System's Walk-Through Documentation Form to obtain an understanding of the three elements of the internal control structure — the control environment, the accounting system, and control procedures.



Audit Planning Memorandum
(Continued)

C. Overall Materiality Limit

Because of the previously mentioned factors, the overall materiality limit will be \$30,000 (see Materiality Computation Form). Immaterial account balances will be so noted on the trial balance and excluded from testing.

D. Sampling

Sampling will be applied to counting, pricing and clerically testing inventories, and to confirming accounts receivable because it is the most cost-effective way to audit these areas. Other procedures for other audit areas will be based on the examination of individually significant items.

Because of the high overall engagement risk, the acceptable risk of incorrect acceptance for sampling applications will be low. Based on prior experience, the expected population misstatement amounts are low. Planned reliance, with the exception of sales cutoff errors discovered in prior TOBs, will be moderate for all financial statement classifications. Sales cutoff tests will be expanded to compensate for errors discovered in the prior TOBs.

See applicable working papers documenting the selection process and sample sizes for specific sampling applications.

E. Audit Approach

The assessed level of control risk is at the maximum. A system's walk-through will be performed for all transaction cycles to obtain an understanding of the accounting system. Analytical procedures will be used to reduce tests of balances.

F. Key Engagement Areas

Key engagement areas, based on the risk and materiality associated with each, are considered to be:

- Inventories,
- Deferred income tax liabilities and assets,
- Related party transactions, and
- Loan covenant compliance.

Audit Planning Memorandum

(Continued)

G. Planning Analytical Procedures

Based upon the results of the analytical procedures performed, only limited tests of balances need be performed in the following areas:

- Prepaid expenses,
- Rent expense,
- Payroll.

The following area's tests of balances should be broadened:

- Inventories.

H. Other Special Considerations

Prepared by: Sam Sartain
(In-charge)

Date: 10/28/x4

Reviewed by: Sara Miller
(Engagement Partner)

Date: 11/1/x4

CHAPTER 8
SMALL BUSINESS ANALYTICAL PROCEDURES PROGRAM

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CHAPTER 8

SMALL BUSINESS ANALYTICAL PROCEDURES PROGRAM

8.000 PURPOSE

8.001 The Small Business Analytical Procedures Program (section 8.300) has been designed to facilitate the selection and performance of analytical procedures in small business audits. Because analytical procedures are often the most cost-beneficial form of evidence, they should be used to the maximum extent practical in small business audit engagements. To help identify problems and generate engagement time savings, the procedures should be performed as early as possible.

8.002 Analytical procedures will vary according to the nature of the client and the auditor's objectives. They should be performed during all phases of the audit. If an unadjusted trial balance is not available during planning, minimum procedures may consist of reviewing changes in the current year's general ledger account with prior year's balances. Results of analytical procedures for clients in certain industries can be compared to industry data. Such comparisons should be used as benchmarks for identifying potential problem areas for further investigation. Analytical procedures should be used to corroborate the results of the tests of balances and should be considered during the in-charge's and engagement partner's review of the engagement.

8.003 Another purpose of analytical procedures is to provide the auditor with a better understanding of the accounting system and operations of the client. This understanding may be used to reduce other substantive tests, as discussed in Chapter 2, and to generate operational suggestions for management. These management suggestions, along with reportable conditions from the evaluation of the internal control structure, should be recorded on the Management Meeting Checklist in section 16.300 of Chapter 16.

8.100 AUTHORITATIVE PRONOUNCEMENTS

8.101 AICPA Statement on Auditing Standards (SAS) No. 56, *Analytical Procedures* (AU 329), requires the use of analytical procedures in the planning and overall review stages of all audits. It states that analytical procedures should be used (1) to assist the auditor in planning the nature, timing, and extent of other auditing procedures; (2) as a substantive test to obtain evidential matter about particular assertions; and (3) as an overall review in the final stage of the audit. Analytical procedures, when combined with other substantive tests and the system's walk-through, make up the evidence necessary to verify the financial statement assertions for small business audits.



8.102 SAS No. 56, paragraph 5 (AU 329.05) describes the nature of analytical procedures:

Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

- a. Financial information for comparable prior period(s) giving consideration to known changes
- b. Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data
- c. Relationships among elements of financial information within the period
- d. Information regarding the industry in which the client operates—for example, gross margin information
- e. Relationships of the financial information with relevant nonfinancial information

8.103 Specific procedures can be classified as either predictive or corroborative depending on their effectiveness in verifying financial statement assertions. Quantity reconciliations and reasonableness tests that predict the balances in accounts, and that are based on reliable information such as the number of units sold times sales price or average interest rates times average notes payable balances, are the most effective analytical procedures. Favorable results from predictive analytical procedures may eliminate the need for other tests of the applicable balance.

8.104 Comparisons of account balances, ratios, and trend analyses are examples of analytical procedures that corroborate the results of other tests. Favorable results from corroborative analytical procedures will reduce other tests of balances. The more effective the corroborative analytical procedure, that is, the lower the level of detail at which it is performed—the greater the reductions in tests of balances will be.

8.105 The Small Business Analytical Procedures Program provides guidance for performing analytical procedures as substantive tests.

8.200 USING THE SMALL BUSINESS ANALYTICAL PROCEDURES PROGRAM

8.201 Before starting field work, the in-charge and the engagement partner should modify the program to fit the specific nature of the engagement, for the client circumstances, for problems discovered in the system's walk-through, and for risk evaluations. Based on the factors outlined above, certain procedures should be marked not applicable "N/A" or not required "N/R."

◆

8.202 If the results of the analytical procedures are not acceptable—that is, the actual results differ significantly from the expected results—the auditor should investigate and evaluate the differences by appropriate follow-up procedures, such as inquiry of management, other substantive tests, etc. If the results of the follow-up procedures are not acceptable, the auditor should modify the tests of Small Business Tests of Balances Audit Program (section 9.200) accordingly.

8.203 The Small Business Analytical Procedures Program should be completed by the in-charge as early in the engagement as possible. If the possibility of material adjustments to specific account balances prevents the immediate performance of certain procedures, they should be completed as soon as the adjusted amounts are determined, to corroborate the results of other substantive procedures.

8.300

Small Business Analytical Procedures Program
Client: <u>ABC Company, Inc.</u>
Financial Statement Date: <u>December 31, 19x4</u>

USE OF PROGRAM:

To provide good client service and perform quality, efficient engagements, analytical procedures should be used extensively throughout small business audit engagements.

Analytical procedures should be used for early identification of problems and misstatements. If the client's records are adjusted prior to the performance of year-end field work, analytical procedures should be completed before beginning tests of balances procedures. Satisfactory completion of the analytical procedures may allow further time savings, through modification of the nature and extent of other substantive tests.

If the client's records are not adjusted prior to the beginning of year-end field work, analytical procedures for accounts not expected to be adjusted should be completed before starting tests of balances procedures, and other procedures performed as soon as adjustments are completed.

Certain analytical procedures have also been incorporated in the Small Business Tests of Balances Audit Program (TOB program). They should be utilized whenever feasible.

INSTRUCTIONS:

The standard analytical procedures program should be modified by the in-charge and approved by the engagement partner before its use on each engagement. The "N/A" column can be initialed for any steps *not applicable*. The "N/A" column can also be marked "N/R" for steps *not required* because of immateriality or other reasons.

The engagement partner should review the program and related documentation upon their completion.

Analytical procedures should be summarized on a working paper such as the Analytical Procedures Working Paper. The summarized procedures should be supported by other working paper documentation as necessary. Variances resulting from highly effective analytical procedures should be included on the Summary of Possible Journal Entries Form for consideration during misstatement analysis.

SMALL BUSINESS ANALYTICAL PROCEDURES PROGRAM

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results? (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of TOBs for "No" Answers
I. CASH								
1. Compare account balances with preceding year's. Investigate significant changes.	SS	1/15/85		AP-2	yes			
2. Compute quick current ratios (cash and net receivables) and compare with preceding year's.	SS	1/15/85						
3. Determine if any bank balances exceed FDIC-insured limits.	SM	1/15/85						
II. ACCOUNTS RECEIVABLE AND SALES								
1. Compare balances of accounts receivable and sales with preceding year's. Investigate significant changes.	SS	1/15/85		AP-2	No	AP-1/2	yes	
2. Investigate large and/or unusual balances classified as "other accounts receivable."			SS					
3. Compute the following ratios and compare with preceding year's:								
a. Number of days net sales in year-end trade accounts receivable	SS	1/15/85		AP-1	No	AP-1/2	yes	
b. Year-end trade accounts receivable as a percentage of gross sales			SS					
c. Accounts receivable turnover			SM					
d. Average accounts receivable collection period			SM					
III. ALLOWANCE FOR DOUBTFUL ACCOUNTS								
1. Compare balances in allowance for doubtful accounts, bad debts, sales returns, and allowances for the preceding year's. Investigate significant changes.	SS	1/15/85		AP-2	yes			

SMALL BUSINESS ANALYTICAL PROCEDURES PROGRAM

(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results? (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of TOBs for "No" Answers
2. Compute the following ratios and compare with preceding year's:								
a. Sales returns and allowances as a percentage of gross sales	SS	1/19/x5		AP-3	Yes			
b. Sales returns and allowances as a percentage of gross sales by product line			SS					
c. Bad debts expense as a percentage of gross credit sales	SS	1/15/x5		AP-3	Yes			
d. Allowance for doubtful accounts as a percentage of trade accounts receivable	SS	1/15/x5		AP-3	Yes			
e. Aging categories as a percentage of total accounts receivable compared to prior year's	SS	1/18/x5		AP- 1/3	Yes			
IV. NOTES AND OTHER ACCOUNTS RECEIVABLE								
1. Compare balances in notes receivable and related interest income with the preceding year's. Investigate significant changes.	SS	1/15/x5		AP-3	Yes			
2. Compute the ratio of interest earned to the average notes receivable outstanding and compare with prior year's.			SS					
V. INVENTORIES								
1. Compare balances in inventories and costs of sales classifications with the preceding year's.	SS	3/2/x5		AP-2	Yes			
2. Compare inventory classifications as a percentage of total inventory with preceding year's.	SS	3/2/x5		AP- 1/2	No	AP-2/1-1	Yes	
3. Compute the following ratios and compare with preceding year's:								
a. Total gross margin			SM					
b. Gross margin by product line or division			SM					

SMALL BUSINESS ANALYTICAL PROCEDURES PROGRAM
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results? (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of TOBs for "No" Answers
c. Total inventory turnover			SM					
d. Inventory turnover by major product, division, or class			SM					
4. Compare inventory replacement values with insurance coverage.	SM	2/3/85		AP-2	Yes			
VI. MARKETABLE SECURITIES								
1. Compare balances in marketable securities and related revenue and expense accounts with the preceding year's. Investigate significant changes.			SS					
2. Compute rate of return on major classes of marketable securities and compare with preceding year's.			SS					
VII. PREPAID EXPENSES								
1. Compare balances in prepaid expense accounts with preceding year's. Investigate significant changes.	SS	3/2/85		AP-3	Yes			
VIII. FIXED ASSETS								
1. Compare balances in fixed assets, with capitalized leased assets, accumulated depreciation, accumulated amortization, depreciation, repairs and maintenance, rents, supplies, small tools, and similar expense accounts with preceding year's. Investigate significant changes.	SS	1/15/85		AP-2	Yes			
2. Compute average lives of depreciable or amortizable assets and compare with prior year's.	SM	1/10/85		AP-2	Yes			
3. Compare fixed asset replacement values with insurance coverage.	SM	1/10/85		AP-2	Yes			

SMALL BUSINESS ANALYTICAL PROCEDURES PROGRAM

(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results? (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of TOBs for "No" Answers
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IX. DEFERRED CHARGES AND INTANGIBLES

1. Compare balances in deferred charges, intangibles, accumulated amortization, and research and development accounts with the preceding year's. Investigate significant changes. SS
2. Compute average amortization period and compare with prior years. SS
3. Consider adequacy of business interruption insurance coverage. SS

X. ACCOUNTS PAYABLE AND PURCHASES

1. Compare balances in trade accounts payable and purchases with the preceding year's. Investigate significant changes. SS 3/2/x5 AP-2 yes
2. Compute the following ratios and compare with preceding year's. Investigate significant changes:
 - a. Accounts payable turnover, or average accounts payable payment period SS
 - b. Percent of year-end trade accounts payable to purchases, or number of days purchases in year-end trade accounts payable SS

XI. OTHER CURRENT LIABILITIES

1. Compare balances in other liability accounts to the preceding year's. Investigate significant changes. SS 1/15/x5 AP-2 yes

XII. NOTES PAYABLE AND LONG-TERM DEBT

1. Compare balances in notes payable, long-term debt and interest expense with preceding year's. Investigate significant changes. SS 1/15/x5 AP-2 yes

SMALL BUSINESS ANALYTICAL PROCEDURES PROGRAM
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results? (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of TOBs for "No" Answers
2. Compute the following ratios and compare to preceding year's:								
a. Long-term debt to stockholders' equity			SS					
b. Interest expense as a percentage of average balance of notes payable and long-term debt outstanding	SS	1/15/x5		AP-3/4	Yes			
XIII. STOCKHOLDERS' EQUITY								
1. Compare balances in stockholders' equity accounts with the preceding year's. Investigate significant changes.	SS	1/15/x5		AP-2	Yes			
XIV. SALARIES, WAGES, AND COMMISSIONS								
1. Compare account balances with the preceding year's. Investigate significant changes.	SS	1/15/x5		AP-2	Yes			
2. Compute the following as a percentage of net sales:								
a. Direct labor	SS	1/15/x5		AP-3	Yes			
b. Indirect labor			SS					
c. Commissions			SS					
d. Office salaries	SS	1/15/x5		AP-3	Yes			
3. Compute payroll tax expense as a percentage of total wages, salaries, and commissions.			SS					
4. Consider adequacy of key person life insurance coverage.			SS					
XV. EXPENSE ACCOUNTS								
1. Compare balances in expense accounts with the preceding year's. Investigate significant differences.	SS	1/15/x5		AP-2	No	AP-2/f4	No	WR AP-2/2

SMALL BUSINESS ANALYTICAL PROCEDURES PROGRAM

(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results? (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of TOBs for "No" Answers
2. Compare individual expense accounts with budgeted amounts. Investigate significant variations.			SS					
3. Compare individual expense accounts as a percentage to total expenses for the following categories:								
a. Selling expenses	SS	1/15/15	SS	AP-2	Yes			
b. Manufacturing expenses	SS	1/15/15		AP-2	No	AP-2/12/14	No	WR AP 2/2
c. General and administrative expenses								

Prepared by: Sam Sartain (In-charge) Date: 2/1/15

Reviewed by: Lara Miller (Engagement Partner) Date: 2/15/15

CHAPTER 9
SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

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CHAPTER 9

SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

9.000 PURPOSE

9.001 The Small Business Tests of Balances Audit Program (section 9.200) is designed to provide substantive evidence, when combined with evidence from the Analytical Procedures and System's Walk-Through procedure, that is sufficient to verify the financial statement assertions in the given client's circumstances. The Program should be modified for each small business audit to reflect the overall engagement risk evaluation based on the Client Acceptance and Continuance Form (Chapter 3, section 3.400), the risk of potential misstatements noted on the Small Business System's Walk-Through Documentation Form (Chapter 5, section 5.600), and the results of the analytical procedures noted in the Small Business Analytical Procedures Program (Chapter 8, section 8.300).

9.002 Four basic types of tests in collecting evidence are recognized in the professional standards:

1. Tests of controls—inquiry-type
2. Tests of controls—reperformance
3. Analytical procedures
4. Tests of balances

9.003 Evidence necessary to achieve the desired level of assurance in a given client's circumstances can be obtained from a mix of these types of tests.

9.004 The System's Walk-Through Approach to small business audits described in this Manual is based primarily on the following types of tests and procedures:

1. The system's walk-through procedure (to obtain an understanding of the internal control structure)
2. Analytical procedures
3. Tests of balances

9.005 As discussed in Chapter 2, "Approach to Performing Small Business Engagements," the degree of reliance on types of tests for the small business audit will normally be as follows:

1. The system's walk-through—none or very low
2. Analytical procedures—high
3. Tests of balances—high

9.006 High reliance on a type of test means using procedures that are the most reliable, selecting large sample sizes, and applying most tests of balances as of the balance-sheet date. Low reliance means the opposite. The system's walk-through procedure provides an understanding of the client's internal control structure.

9.007 High reliance on a type of test or procedure will result in collecting more and better evidence that, in turn, will mitigate high overall engagement risk and/or a high risk of potential misstatements. In cases where these risks are low, there is an opportunity to decrease slightly the reliance on tests of balances, that is, we can use certain less reliable procedures, slightly smaller sample sizes, and possibly perform some substantive tests at interim dates. Chapter 2 discusses the evidence design process in small business audits.

9.008 The Small Business Tests of Balances Audit Program is designed to verify the financial statement assertions from AICPA Statement on Auditing Standards (SAS) No. 31, *Evidential Matter* (AU 326). These assertions are—

Existence or Occurrence

To determine that all recorded assets and liabilities exist at a given date (validity), and all transactions occurring during the period have been recorded (cutoff)

Completeness

To determine that all transactions and accounts that should be presented have been included in the financial statements

Rights and Obligations

To determine that the entity has rights to all assets recorded at a given date (ownership), and that all liabilities are obligations of the entity at a given date

Valuation or Allocation

To determine that all asset, liability, revenue, and expense components have been included in the financial statements at appropriate amounts (classification, cutoff, mechanical accuracy)

Presentation and Disclosure

To determine that all components of the financial statements are properly classified, described, and disclosed

◆

9.009 The financial statement assertions addressed above have been tied into the Small Business Tests of Balances Audit Program steps that satisfy each specific assertion. For example, in the cash tests of balances audit program Step B.4., "Prepare and mail the Standard Form to Confirm Account Balance Information With Financial Institutions for demand and time deposit accounts. (E, C, and R)," the existence or occurrence, completeness, and rights and obligations assertions are satisfied. This program step satisfies the existence or occurrence assertion by the auditor's confirming with an outside source the existence of cash; it satisfies the completeness assertion by the auditor's confirming the completeness of this specific account; and it satisfies the rights and obligations assertion by the auditor's confirming the right to this cash.

9.100 USING THE SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

9.101 The in-charge should modify the standard program based on the evaluation of overall engagement risk from the Client Acceptance and Continuance Form, the risk of potential misstatements discovered while completing the Small Business System's Walk-Through Documentation Form, and the results of the Small Business Analytical Procedures Program. The engagement partner should review the program after the system's walk-through procedure and, if possible, after the analytical procedures have been completed. Any procedures which the auditor considers inapplicable due to immateriality of the account balance or nonexistence of the section should be marked "N/A" or "N/R."

9.102 Tests of balances can be made more efficient and reliable by the use of various sampling techniques. Nonstatistical sampling applications for substantive tests of balances on small business audit engagements are discussed in detail in Chapter 7.

9.200

Small Business Tests of Balances Audit ProgramClient: ABC Company, Inc.Financial Statement Date: December 31, 19X4**INSTRUCTIONS:**

This program should be used on small business audit engagements when planned reliance on tests of balances procedures will normally be high, that is, more reliable procedures will be performed using larger sample sizes at or near the balance-sheet date.

The nature, extent and timing of the tests of balances procedures will, however, be modified by the in-charge based on the results of completing the Small Business System's Walk-Through Documentation Form and the Small Business Analytical Procedures Program. Any procedures the auditor considers inapplicable due to immateriality of the account balance or nonexistence of the section should be marked "N/A" for not applicable or "N/R" for not required in the "Done by" column.

Each program step is referenced to the financial statement assertions that it addresses. For example, in the cash tests of balances audit program step number B.4, "Prepare and mail the Standard Form to Confirm Account Balance Information With Financial Institutions for demand and time deposit accounts. (E, C, and R)," the existence or occurrence, completeness, and rights and obligations assertions are satisfied. This program step satisfies the existence or occurrence assertion by confirming with an outside source the existence of cash, it satisfies the completeness assertion by confirming the completeness of this specific account, and it satisfies the rights and obligations assertion by confirming the right to this cash.

SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM**INDEX**

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SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

I. CASH

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Presentation and disclosure (P)

Objectives

- Existence—To determine that cash exists and is owned by the entity (assertions E and R)
- Proper cutoff—To determine that cash balances reflect a proper cutoff of cash receipts and disbursements (assertions E, C, and P)
- Complete—To determine that cash balances as presented in the balance sheet properly reflect all cash and cash items on hand, in transit, or on deposit with third parties (assertions E, C, and P)
- Proper classification—To determine that cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed (assertions R and P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program to determine the nature, timing, and extent of auditing procedures. (E, C, and R)	<u>SS</u>	<u>1/14/X5</u>	<u> </u>
B. At balance-sheet date:			
1. Count undeposited funds on hand and control until deposited. (E and R)	<u>JT</u>	<u>1/14/X5</u>	<u>A-1</u> <u>A-2</u>
2. Count petty cash and pay particular attention to the nature of transactions. (E and R)	<u>JT</u>	<u>1/14/X5</u>	<u> </u> <u> </u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

I. CASH (Continued)

Procedures	Done by	Date	W/P Ref.
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Practice Tip

It is often a good idea to scan petty cash vouchers to determine types of expenses that are paid out of petty cash. Be alert for items that might need to be capitalized.

- | | | | |
|--|-----------|----------------|------------|
| 3. List any checks prepared and recorded prior to the balance-sheet date, but not yet mailed. (C) | <u>JJ</u> | <u>1/14/85</u> | A-1
A-2 |
| 4. Prepare and mail the Standard Form to Confirm Account Balance Information With Financial Institutions for demand and time deposit accounts. (E, C, and R) | <u>JJ</u> | <u>1/14/85</u> | A-1
A-2 |

Practice Tip

All confirmation and cutoff requests should be mailed by the auditor.

- | | | | |
|--|-----------|----------------|------------|
| 5. Prepare and mail a request for cutoff bank statements on bank accounts to be sent directly to us. (E, C, and R) | <u>JJ</u> | <u>1/14/85</u> | A-1
A-2 |
| C. Obtain bank reconciliations for <u>3</u> accounts as of the balance-sheet date and — | | | |
| 1. Foot reconciliations. | <u>JJ</u> | <u>1/14/85</u> | A-3 |
| 2. Trace book balances to the general ledger. | <u>JJ</u> | <u>1/14/85</u> | A-3 |
| 3. Trace bank balances to cutoff bank statements. | <u>JJ</u> | <u>1/14/85</u> | A-3 |
| 4. Agree bank balances to confirmations from the bank. | <u>JJ</u> | <u>1/14/85</u> | A-3 |



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
I. CASH (Continued)

Procedures	Done by	Date	W/P Ref.
5. Trace reconciling items, on a test basis, to bank cutoff statements or other supporting documents. Items not clearing during the cutoff period should be challenged for propriety and traced to supporting documents.	<u>JT</u>	<u>1/14/05</u>	<u>A-3</u>
6. Determine that items in bank cutoff statements relating to periods before, or on, the reconciliation date are properly reflected on the reconciliation.	<u>JT</u>	<u>1/14/05</u>	<u>A-3</u>
7. Examine enclosures returned with bank cutoff statements for any unusual items or unrecorded transactions taking place before and after the balance-sheet date.	<u>JT</u>	<u>1/14/05</u>	<u>A-3</u>
8. For checks dated for the first <u>7</u> days after the reconciliation date, on a test basis, examine the date of the first bank endorsement to determine if they precede the reconciliation date.	<u>JT</u>	<u>1/14/05</u>	<u>A-3</u>
9. Trace lists of any held checks to outstanding check lists. (E, C, and R)	<u>JT</u>	<u>1/14/05</u>	<u>A-3</u>
D. Prepare or obtain a schedule of interbank and intrabank transfers for _____ days before and after the balance-sheet date and determine that:			
1. All such transfers were recorded on the books in the same period for bank accounts involved.	<u>JT</u>	<u>1/14/05</u>	<u>A-6</u>
2. Uncompleted transfers were properly accounted for in the bank reconciliations. (E, C, and R)	<u>N/A</u>	_____	_____
E. Segregate any bank overdrafts or funds subject to withdrawal restrictions. (P)	<u>N/A</u>	_____	_____
F. Review any compensating balance arrangements for the benefit of the client or related parties. (P)	<u>N/A</u>	_____	_____
G. Determine amounts, if any, of bank statement balances that exceed FDIC-insured limits at balance-sheet date. (P)	<u>N/A</u>	_____	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

I. CASH (Continued)

Procedures	Done by	Date	W/P Ref.
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H. Additional procedures:

Prepared by: James Jacob Date: 1/15/05

Reviewed by: John King Date: 1/17/05



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

II. TRADE ACCOUNTS RECEIVABLE

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Existence—To determine that receivables exist, are authentic obligations owed to the entity, and contain no significant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive (assertions E, R, and V)
- Proper disclosure—To determine that proper disclosure is made of any pledged, discounted or assigned trade receivables (assertions R and P)
- Revenue recognition—To determine that interest on trade accounts receivable has been properly recorded (assertions C, R, and V)
- GAAP conformity—To determine that presentation and disclosure of trade accounts receivables are in conformity with GAAP consistently applied (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the Small Business System's Walk-Through Documentation Form and the results of the applicable sections of the Analytical Procedures Program, and determine their impact on the nature, extent, and timing of accounts receivable tests of balances procedures. (E, C, R, and V)	<u>SS</u>	<u>1/16/25</u>	<u> </u>
B. Obtain or prepare a list of aged accounts receivable at the balance-sheet date, foot, and trace to the general ledger (or prepare adjusting entry to reconcile). (E and C)	<u>SS</u>	<u>1/16/25</u>	<u> </u>
C. Trace <u>15</u> accounts to underlying sales invoices and collections documentation for name, amount, and aged categories. (E and V)	<u>SS</u>	<u>1/16/25</u>	<u>B-1</u>
D. Review and document gross collections for accounts receivable for <u> </u> days after balance-sheet date. (E, R, and V)	<u>JJ</u>	<u>1/20/25</u>	<u>B-1</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
II. TRADE ACCOUNTS RECEIVABLE (Continued)

Procedures	Done by	Date	W/P Ref.
E. Request confirmation of accounts receivable as follows:			
1. Positive requests for individually significant accounts with balances in excess of \$ <u>5,000</u>	<u>SS</u>	<u>1/18/x5</u>	<u>B-1</u>
2. Positive requests for accounts from the sampling population as follows: _____ _____ _____	<u>SS</u>	<u>1/18/x5</u>	<u>B-1</u>
3. Negative requests on accounts from the sampling population as follows: _____ _____ _____	<u>N/A</u>		

(E, R, and V)

Practice Tip

All confirmation requests should be mailed by the auditor.

F. Select _____ accounts and independently verify addresses by reference to phone or business directories, phone calls to customers, documents received from customer credit checks, etc. (E, R, and V)	<u>N/A</u>		
G. Send second requests for positive nonreplies. (E, R, and V)	<u>JJ</u>	<u>2/5/x5</u>	<u>B-1</u>
H. Perform alternative procedures for nonreplies to second requests by examining subsequent collections documentation and, if there are no or partial collections, shipping reports and/or sales invoices. (E, R, and V)	<u>JJ</u>	<u>2/5/x5</u>	<u>B-1</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
II. TRADE ACCOUNTS RECEIVABLE (Continued)

Procedures	Done by	Date	W/P Ref.
I. Reconcile all confirmation exceptions by reference to supporting documents. (E, R, and V)	<u>N/A</u>	_____	_____
<p>Practice Tip</p> <p>Be alert for large credits claimed by customers (especially close to the balance-sheet date). These credits may represent goods that were never sent, thereby affecting ending inventory.</p>			
J. Summarize the results of the confirmation procedures. (E, R, and V)	<u>SS</u>	<u>2/10/25</u>	<u>B-2</u>
K. Test sales cutoff by tracing entries in the sales journal for <u>5</u> days before and <u>5</u> days after the balance-sheet date to shipping reports, if available, and/or sales invoices. (E and C)	<u>JT</u>	<u>1/29/25</u>	<u>B-3</u>
L. Determine, confirm, and disclose accounts pledged, discounted, sold, assigned, or guaranteed by others. (R and P)	<u>N/A</u>	_____	_____
M. Reclassify any material credit balances. (P)	<u>N/A</u>	_____	_____
N. For low risk engagements, when sending confirmations at an interim date, perform the following in addition to the steps above:			
1. Select confirmations from a source that is reconciled to the general ledger.	<u>N/A</u>	_____	_____
2. Review transactions from the confirmation date to the balance-sheet date for material or unusual items. Review supporting documents for such transactions.	<u>N/A</u>	_____	_____
3. Consider confirming several material account balances at the balance-sheet date.	<u>N/A</u>	_____	_____
Positive _____			
Negative _____			
(E, R, and V)			



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
II. TRADE ACCOUNTS RECEIVABLE (Continued)

Procedures	Done by	Date	W/P Ref.
O. Determine amounts, if significant, of concentrations of receivables such as major customers, industries, geographical areas, etc. (P)	N/A	_____	_____
P. Additional procedures:			

Prepared by: Sam Sartain Date: 2/10/15

Reviewed by: John King Date: 2/11/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

III. OTHER ACCOUNTS RECEIVABLE

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Existence—To determine that the other receivables exist, are authentic obligations owed to the entity, and contain no significant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive (assertions E, R, and V)
- Proper disclosure—To determine that proper disclosure is made of any pledged, discounted, or assigned receivables (assertions R and P)
- Revenue recognition—To determine that interest on other accounts receivable has been properly recorded (assertions C, R, and V)
- GAAP conformity—To determine that presentation and disclosure of other accounts receivables are in conformity with GAAP consistently applied (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess the impact on tests of balances. (E, C, R, and V)	SS	1/19/25	—
B. Inquire about the existence of other accounts receivable. Determine that all have been recorded. (C)	SS	1/19/25	—
C. Obtain a list of other accounts receivable, foot, and agree to the general ledger. (E, C, and R)	SS	1/19/25	B-7
D. Request positive confirmations of all significant balances. Send second requests for nonreplies. (E, R, and V)	SS	1/19/25	B-7



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
III. OTHER ACCOUNTS RECEIVABLE (Continued)

Procedures	Done by	Date	W/P Ref.
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Practice Tip

All confirmation requests should be mailed by the auditor.

- | | | | |
|--|-----|--|--|
| E. Perform alternative procedures on nonreplies to second requests (for example, subsequent receipts). (E, R, and V) | N/A | | |
| F. Reconcile any exceptions received. (E, R, and V) | N/A | | |
| G. Separately classify related-party receivables. (P) | N/A | | |
| H. Additional procedures: | | | |
| _____ | | | |
| _____ | | | |
| _____ | | | |
| _____ | | | |

Prepared by: Sam Sartain Date: 1/19/15

Reviewed by: John King Date: 1/25/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

IV. NOTES RECEIVABLE

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Existence—To determine that the notes receivable exist, are authentic obligations owed to the entity, and contain no significant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive (assertions E, R, and V)
- Proper disclosure—To determine that proper disclosure is made of any pledged, discounted, or assigned notes receivable (assertions R and P)
- Revenue recognition—To determine that interest on notes receivable has been properly recorded (assertions C, R, and V)
- GAAP conformity—To determine that presentation and disclosure of notes receivable are in conformity with GAAP consistently applied (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess the impact on tests of balances. (E, C, R, and V)	<u>N/A</u>	_____	_____
B. Inquire about the existence of notes receivable. Determine that all have been recorded. (E, C, and R,)	<u>SS</u>	<u>1/19/15</u>	_____
C. Obtain a list of notes receivable, foot, and agree to the general ledger. (E and C)	<u>SS</u>	<u>1/19/15</u>	<u>B-8</u>
D. Examine properly signed and dated notes and any collateral supporting balances due. (E, R, and V)	<u>SS</u>	<u>1/19/15</u>	<u>B-8</u>
E. Request positive confirmation on all significant balances. Send second requests for nonreplies. (E, R, and V)	<u>SS</u>	<u>1/19/15</u>	<u>B-8</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
IV. NOTES RECEIVABLE (Continued)

Procedures	Done by	Date	W/P Ref.
------------	---------	------	-------------

Practice Tip

All confirmation requests should be mailed by the auditor.

- | | | | |
|---|-----|--|--|
| F. Examine evidence of periodic or subsequent collections on nonreplies to second requests. (E, R, and V) | N/A | | |
| G. Reconcile any confirmation exceptions received. (E, R, and V) | N/A | | |
| H. Separately classify notes from related parties. (P) | N/A | | |
| I. Test the calculation of any accrued interest receivable and consider reconciling to interest income. (E) | N/A | | |
| J. Additional procedures: | | | |
| _____ | | | |
| _____ | | | |
| _____ | N/A | | |

Prepared by: Sam Sartain Date: 1/19/15

Reviewed by: John King Date: 1/26/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

V. ALLOWANCE FOR DOUBTFUL ACCOUNTS

Financial Statement Assertions

Valuation or allocation (V)
Presentation and disclosure (P)

Objectives

- Amount appropriate—To determine that allowances for doubtful accounts are adequate and not excessive (assertion V)
- Proper disclosure—To determine that proper disclosure is made of any allowances for doubtful accounts (assertion P)
- GAAP conformity—To determine that presentation and disclosure of allowance for doubtful accounts are in conformity with GAAP consistently applied (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess the impact on tests of balances. (V)	<u>SS</u>	<u>1/19/25</u>	—
B. Obtain an analysis of the bad debt expense and allowance accounts for the year, foot, and tie to the general ledger. Challenge the reasonableness of the chargeoffs and recoveries. Discuss with management. (V and P)	<u>SS</u>	<u>1/19/25</u>	<u>B-9</u>
C. Examine correspondence files and discuss with management reasons for significant write-offs during the year. (V)	<u>SS</u>	<u>1/19/25</u>	—
D. Review the aged trial balance and other lists of notes and accounts (that were footed and tied to the general ledger) and discuss balances over <u>90</u> days old with management. Determine the need to include such accounts in the allowance. (V)	<u>SS</u>	<u>1/19/25</u>	<u>B-1</u>
E. Examine credit memos issued after the balance-sheet date and determine the need for an allowance for discounts, returns, and allowances. (V)	<u>JT</u>	<u>1/20/25</u>	<u>B-10</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
V. ALLOWANCE FOR DOUBTFUL ACCOUNTS (Continued)

Procedures	Done by	Date	W/P Ref.
F. Summarize the results of the procedures above and evaluate the adequacy of the allowance. (V)	<u>SS</u>	<u>1/21/15</u>	<u>B-9</u>
G. Additional procedures:			

_____	<u>N/A</u>		

Prepared by: Sam Sustain Date: 1/21/15
 Reviewed by: John King Date: 1/25/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

VI. INVENTORY OBSERVATION

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Valuation or allocation (V)

Objectives

- Existence—To determine that the inventory exists (assertion E)
- Quantity and condition—To determine that the client has taken reasonable care in determining the physical quantities and identifying the condition (normal, slow moving, or obsolete) of its inventory (assertions C and V)

Procedures	Done by	Date	W/P Ref.
A. Review the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess their impact on the nature, extent, and timing of inventory tests of balances procedures. (E, C, and V)	<u>SS</u>	<u>1/21/25</u>	_____
B. Review the client's plans for taking inventory at all locations; controlling tags and count sheets; identifying obsolete items and consigned and customers' goods; controlling the movement of inventory during the count; and controlling shipping and receiving. (E, C, and V)	<u>SS</u>	<u>9/28/24</u>	_____
C. Review or assist in preparing physical inventory instructions. (E, C, and V)	<u>SS</u>	<u>10/11/24</u>	<u>C-3</u>
D. Review last year's inventory summaries and current production records. Consider selecting representative test count items in advance. (E, C, and V)	<u>SS</u>	<u>12/31/24</u>	_____
E. Observe the taking of the physical inventory:			
1. Obtain a copy of the tag or sheet control form. (E and C)	<u>SS</u>	<u>12/31/24</u>	<u>C-4</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
VI. INVENTORY OBSERVATION (Continued)

Procedures	Done by	Date	W/P Ref.
2. Obtain the last receiving and shipping report numbers and sales invoice numbers. (E and C)	<u>JT</u>	<u>12/31/24</u>	<u>C-5</u>
3. Determine that the movement of goods is controlled during the count and that the physical cutoff is proper. (E and C)	<u>JT</u>	<u>12/31/24</u>	<u>C-5</u>
4. Identify and record any obsolete goods for follow-up. (V)	<u>SS</u>	<u>12/31/24</u>	<u>C-6</u>
5. Observe counting and recording procedures by all inventory crews to ensure that inventory instructions are being followed. (E, C, and V)	<u>SS</u>	<u>12/31/24</u>	_____
6. Make and record representative test counts for later tracing to client's inventory computation sheets as follows:			
a. Record counts for individually significant items with totals in excess of \$ <u>10,000</u> .	<u>SS</u>	<u>12/31/24</u>	<u>C-7</u>
b. Record counts for representative items from the sampling population as follows:			

_____	<u>JT</u>	<u>12/31/24</u>	<u>C-8</u>

(E and C)			
7. See that tags or count sheets contain adequate descriptions, units of measure, last operation completed (for work in process), and appraisal of inventory condition if obsolete or slow-moving. (E, C, and V)	<u>SS</u>	<u>12/31/24</u>	_____
8. Make a final walk-through to determine that all goods were counted, obsolete or consigned goods were identified and that all inventory tags or sheets were collected. (E, C, and V)	<u>SS</u>	<u>12/31/24</u>	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
VI. INVENTORY OBSERVATION *(Continued)*

Procedures	Done by	Date	W/P Ref.
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Practice Tip

Be alert for inventory items that appear old (for example, last year's inventory tag is still attached; items are dusty from non-use). Sometimes, general conversations with client personnel taking inventory will help identify old goods.

9. Prepare a memo describing the observation procedures and conclusions reached. (E, C, and V)

SS 1/4/15 C-9

F. Additional procedures:

N/A _____ _____

Prepared by: Sam Sartin Date: 1/5/15

Reviewed by: John King Date: 1/25/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

VII. INVENTORIES (NO PERPETUAL RECORDS)

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Existence—To determine that the inventory exists and is the client's property (assertions E and R)
- Clerical accuracy—To determine that the inventories are summarized and priced with clerical accuracy, and that the records have been adjusted to the physical inventory (assertions C and V)
- GAAP conformity—To determine that inventory classifications and carrying amounts are determined and presented in the financial statements in conformity with GAAP consistently applied (for example, assumptions about the cost flow, such as FIFO and LIFO, and lower of cost or market considerations) (assertion P)
- Encumbrances identified—To determine that any encumbrances such as pledges or liens, are identified and adequately disclosed in the financial statements (assertions R, V, and P)

Procedures	Done by	Date	W/P Ref.
A. Prepare any necessary inventory adjustments, or review client's adjustments, and complete the Small Business Analytical Procedures Program. (E, C, and V)	<u>SS</u>	<u>1/21/05</u>	_____
B. Review the Small Business System's Walk-Through Documentation Form, and Small Business Analytical Procedures Program, and assess their impact on the nature, extent, and timing of inventory tests of balances procedures. (E, C, and V)	<u>SS</u>	<u>1/21/05</u>	<u>C-21</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
VII. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Procedures	Done by	Date	W/P Ref.
C. Trace shipping and receiving report numbers obtained during inventory observation to determine that they were recorded in the proper period.	JT	1/21/15	C-5
1. Examine shipping and receiving reports for <u>5</u> days before and after the inventory date, trace to the appropriate source journal and cutoff numbers, and determine that a proper cutoff was made. (E, R, and C)	JT	1/21/15	C-5
2. Review reconciliation of inventory if counted at other than the balance-sheet date. Examine supporting documents or source journals for major items on reconciliation. (E and C)	N/A		
3. Review credit memos for <u>10</u> days before and after balance-sheet date to determine that they were recorded in the proper period. (E and C)	JT	1/21/15	B-10
D. Obtain a copy of the client's final inventory summary, foot, agree to general ledger, and trace <u>15</u> items to and from tags or sheets control form. (E and C)	JT	1/16/15	C-1
E. Trace test counts to summary and inventory sheets taken at physical. (E and C)	JT	1/16/15	C-7/8
F. Determine that all individually significant items test counted are included in the summary and extended and footed properly. (C and V)	JT	1/16/15	C-3
G. Foot <u>2</u> pages and <u>2</u> page totals and extend <u>5</u> line items in the sampling population. (V)	JT	1/16/15	C-1
H. Review the summary to determine that obsolete goods noted during observation have been excluded or priced at net realizable value. (V)	JT	1/16/15	C-1
I. Compare major item categories with the prior year's and investigate material changes. (E, C, and V)	JT	1/16/15	C-1



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
VII. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Procedures	Done by	Date	W/P Ref.
J. 1. Determine the client's pricing method for raw materials and select items for price testing from the sampling population as follows: (V) _____ _____ _____	N/A	_____	_____
2. Compare prices to vendor invoices or price lists. If the client uses the LIFO method, additional procedures for testing base prices and computations should be designed and performed. Determine that the method is consistent. (V)	JT	1/17/25	C-2
3. Perform price tests for all individually significant items of raw materials that were included in test counts. (V)	JT	1/16/25	C-3
K. Review <u>10</u> price computations for work in process and finished goods for propriety and consistency. (V)	JT	1/17/25	C-3
L. 1. Support price computations for work in process by reference to invoices, bills of materials and charges, and cost accounting records as follows: (V) _____ _____ _____	JT	1/17/25	C-3
2. Verify price computations for all individually significant items of work in process and finished goods that were included in test counts. (V)	JT	1/17/25	C-3
M. Determine that all classes of inventory have been subjected to tests of replacement costs and/or net realizable value. (V)	SS	1/20/25	C-3



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
VII. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Procedures	Done by	Date	W/P Ref.
N. Test, or prepare, an allocation of overhead to work in process and finished goods. Determine if the method is consistent with prior year's. (V and P)	<u>SS</u>	<u>1/20/25</u>	<u>C-3</u>
O. Determine that customers' goods have been excluded from inventory. If material, consider confirming. (R)	<u>SS</u>	<u>1/20/25</u>	<u> </u>
<div style="border: 1px solid black; padding: 10px; width: fit-content; margin: 10px auto;"> <p>Practice Tip</p> <p>All confirmation requests should be mailed by the auditor.</p> </div>			
P. Determine if any inventory has been pledged. (P)	<u>SS</u>	<u>1/20/25</u>	<u>C-7</u>
Q. For significant amounts of inventory stored at outside locations, consider performing the following procedures:			
1. Review and test the owner's control procedures for investigating and evaluating the warehouseman's performance. (E and C)	<u>N/A</u>	<u> </u>	<u> </u>
2. Obtain an independent auditor's report on the warehouse's control procedures relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouse is reliable. (E and C)	<u>N/A</u>	<u> </u>	<u> </u>
3. Observe physical counts of the goods, if practicable and reasonable. (E and C)	<u>N/A</u>	<u> </u>	<u> </u>
4. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate). (E and P)	<u>N/A</u>	<u> </u>	<u> </u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
VII. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Procedures	Done by	Date	W/P Ref.
5. Confirm goods out on consignment or at outside warehouse. (E, R, and P)	<u>N/A</u>	_____	_____
R. Additional procedures:			

_____	<u>N/A</u>	_____	_____

Prepared by: Sam Sartain Date: 1/21/15

Reviewed by: John King Date: 1/27/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

VIII. INVESTMENT SECURITIES

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Existence—To determine that the entity owns the securities at the balance-sheet date and has physical evidence of ownership (securities, receipts from responsible custodians, etc.) (assertions E, C, and R)
- Proper valuation—To determine that the market or other fair value of the securities has been determined as objectively as practicable (assertion V)
- Income recognition—To determine that related income, gains, and losses from the investment securities is properly recorded and received (assertions C, R, and V)
- Identification of restrictions—To determine that restrictions, pledges, or liens on any of the investment securities and related liabilities are identified and adequately disclosed in the financial statements (assertions E, C, R, and P)
- GAAP conformity—To determine that the financial statement presentation and disclosure of investment securities, including off-balance sheet items such as options and other derivative instruments, and related income, gains, and losses are in conformity with GAAP consistently applied (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable section of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess impact on tests of balances. (E, C, R, and V)	<u>SM</u>	<u>1/10/15</u>	<u>AP-3</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
VIII. INVESTMENT SECURITIES (Continued)

Procedures	Done by	Date	W/P Ref.
B. Obtain a list of securities at balance-sheet date, including descriptions, number of shares, cost, carrying amount, and market value. Foot and tie to the general ledger. Review subsequent transactions to determine the completeness of the list. (E and C)	<u>SM</u>	<u>1/10/25</u>	<u>E-1</u>
C. Examine securities on hand at the balance-sheet date and obtain a receipt for their return. (E and R)	<u>SM</u>	<u>1/10/25</u>	<u>E-2</u>
D. Obtain confirmation of securities held by others at the balance-sheet date. (E, C, and R)	<u>SM</u>	<u>1/10/25</u>	<u>E-2</u>

Practice Tip

All confirmation requests should be mailed by the auditor.

E. 1. Determine that all debt and equity securities are properly classified as held-to-maturity, available-for-sale, or trading by reference to the nature of the security and management's ability and intention to hold. (P)	<u>SM</u>	<u>1/10/25</u>	<u>E-2</u>
2. For debt securities classified as held-to-maturity:			
a. Determine that they are valued at amortized cost. (V)	<u>SM</u>	<u>1/10/25</u>	<u>E-2</u>
b. Recalculate amortized cost. (E,C,V, and P)	<u>SM</u>	<u>1/10/25</u>	<u>E-2</u>
3. For debt and equity securities classified as available-for-sale:			
a. Determine that they are valued at fair value and, on a test basis, agree to third party market value quotations. (E,C,V, and P)	<u>SM</u>	<u>1/10/25</u>	<u>E-2</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

VIII. INVESTMENT SECURITIES (Continued)

Procedures	Done by	Date	W/P Ref.
b. Recalculate unrealized gains and losses and determine that they are included as a separate component of stockholders' equity. (V and P)	<u>SM</u>	<u>1/10/85</u>	<u>E-2</u>
4. For debt and equity securities classified as trading securities:			
a. Determine that they are valued at fair value and, on a test basis, agree to third party market value quotations. (E,C,V, and P)	<u>SM</u>	<u>1/10/85</u>	<u>E-2</u>
b. Recalculate unrealized gains and losses and determine that they are included in earnings. (V and P)	<u>SM</u>	<u>1/10/85</u>	<u>E-2</u>
5. Obtain a schedule of all sales of investment securities, by category, and transfers between categories during the year and determine whether they have been accounted for properly. (Sales of held-to-maturity securities may "taint" the entire category.) (C, V, and P)	<u>SM</u>	<u>1/10/85</u>	<u>E-3</u>
F. Examine brokers' advices and/or directors' approval for major transactions during the period. (E and V)	<u>SM</u>	<u>1/10/85</u>	<u>E-3</u>
G. Obtain a list of all derivative transactions. (E and C)			
1. Examine evidence of the transactions and directors' approval of the transactions. (E, C, and R)	<u>SM</u>	<u>1/10/85</u>	<u>E-4</u>
2. Obtain confirmations of outstanding transactions as of year end. (E)	<u>SM</u>	<u>1/10/85</u>	<u>E-4</u>
3. Review subsequent transactions to determine completeness of the list. (C)	<u>SM</u>	<u>1/10/85</u>	<u>E-4</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
VIII. INVESTMENT SECURITIES (Continued)

Procedures	Done by	Date	W/P Ref.
4. For disclosure purposes obtain and evaluate information concerning significant individual or group concentrations of credit risk. (P)	<u>SM</u>	<u>1/10/25</u>	<u>E-4</u>
5. Determine that any gains or losses have been properly recorded. (V and P)	<u>SM</u>	<u>1/10/25</u>	<u>E-4</u>
H. Determine if any securities are pledged or restricted. (P)	<u>SM</u>	<u>1/10/25</u>	<u>E-2</u>
I. Ensure that all information needed for financial statement disclosures has been accumulated and documented in the workpapers. (Refer to the Small Business Audit Reporting and Disclosure Checklist in Chapter 14.) (P)	<u>SM</u>	<u>1/10/25</u>	_____
J. Additional procedures:			

_____	<u>N/A</u>		

Prepared by: Sam Sartain Date: 1/21/25

Reviewed by: John King Date: 1/21/25



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

IX. PREPAID EXPENSES

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Proper recording—To determine that the balances represent costs that are properly allocable to future periods in conformity with GAAP (assertions E, C, R, and V)
- Support for additions—To determine that additions are adequately supported (assertions E, C, R, and P)
- Appropriateness of amortization—To determine that amortization is determined by a rational and systematic method consistently applied (assertions V and P)
- Recognition of impairment—To determine that any permanent impairment of balance is recognized by writedowns charged to operations (assertions E, C, V, and P)
- Proper classification—To determine that balances and related expenses are properly described and classified in the financial statements (assertion P)
- Disclosure of contingencies—To determine whether there are uninsured risks that should be considered for disclosure (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program, and assess the impact on tests of balances. (E, C, R, and V)	SS	1/10/25	
B. Obtain or prepare schedules of prepaid expenses; foot and tie to general ledger. (E, C, and R).	SS	1/10/25	D-1
C. Confirm insurance policies in force with insurance agent or broker. (P)	N/A		



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
IX. PREPAID EXPENSES (Continued)

Procedures	Done by	Date	W/P Ref.
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Practice Tip:
 All confirmation requests should be mailed by the auditor.

Practice Tip:
 Be alert for insurance confirmations indicating locations of inventory. Trace locations listed to inventory totals to determine that all locations have been included in the inventory summary.

- | | | | |
|---|----|---------|-----|
| D. Trace prepaid insurance schedule, on a test basis, to insurance confirmation and insurance policy. (E, C, and V) | SS | 1/10/25 | D-1 |
| E. Determine the adequacy of insurance coverage by comparison with asset values, as determinable, and discussion with management. (V) | SS | 1/10/25 | --- |
| F. Investigate and support other prepaid expenses as considered necessary. (E, C, and V) | SS | 1/10/25 | D-1 |
| G. Additional procedures:

_____ | NA | --- | --- |

Prepared by: Sam Sartain Date: 1/19/25

Reviewed by: John King Date: 1/20/25



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM**X. FIXED ASSETS**

Financial Statement Assertions

Existence or occurrence (E)
Completeness (C)
Rights and obligations (R)
Valuation or allocation (V)
Presentation and disclosure (P)

Objectives

- Existence—To determine that fixed assets exist and are owned by the entity (assertion E)
- Appropriateness of additions—To determine that fixed asset additions are authentic, recorded at cost, and properly distinguished from maintenance and repairs expense (assertions E, C, and R)
- Recording of retirements—To determine that retirements of fixed assets, proceeds from salvage and related cost to remove are properly recognized (assertions E, C, and V)
- Appropriateness of depreciation—To determine that a proper amount of depreciation expense is allocated to the period based on the asset cost, estimated life and salvage, and use of acceptable methods consistently applied, and adequately presented in the financial statements (assertions V and P)
- Recoverable value—To determine that the net carrying value as presented in the financial statements is expected to be recoverable through the ordinary course of business (assertion V)
- Identification of encumbrances—To determine that any encumbrances and liens are identified and adequately disclosed in the financial statements (assertion P)
- Proper classification—To determine that significant amounts of idle fixed assets are properly stated, classified and described (assertion P)
- Proper disclosure—To determine that significant amounts of fully depreciated assets are considered for disclosure (assertion P)



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
X. FIXED ASSETS (Continued)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and determine the impact on tests of balances. (E, C, R, and V)	<u>SS</u>	<u>1/16/15</u>	<u> </u>
B. Obtain a schedule of fixed assets showing cost, accumulated depreciation, and amortization by beginning balance, additions, retirements, and ending balances. Foot and tie to the general ledger. (E, C, V, and P)	<u>JT</u>	<u>1/17/15</u>	<u>K-1</u>
<p>Practice Tip:</p> <p>If the client has offices in different states, be sure to itemize fixed assets to aid in allocation for income tax calculations and returns.</p>			
C. Obtain detailed schedules of additions and retirements, and—			
1. Foot and tie to fixed asset schedule. (C)	<u>JT</u>	<u>1/17/15</u>	<u>K-1</u>
2. Vouch major additions to vendors' invoices, construction cost records, titles or deeds, or contracts to determine that fixed assets are properly recorded. (E and V)	<u>JT</u>	<u>1/17/15</u>	<u>K-1</u>
3. Physically inspect <u>10</u> assets and/or examine tax bills, deeds, licenses, etc. (E)	<u>JT</u>	<u>1/17/15</u>	<u>K-1</u>
4. Determine that the capitalization policy is consistently applied. (V and P)	<u>JT</u>	<u>1/17/15</u>	<u>K-1</u>
D. Obtain or prepare a schedule of gains and losses on sales of fixed assets. Foot and tie to the general ledger. Trace major amounts to supporting documents and records and review for reasonableness. (E, V, and P)	<u>JT</u>	<u>1/17/15</u>	<u>K-1</u>
E. Review repairs and maintenance, supplies, small tools, and other expense accounts for any assets that should be capitalized. (V)	<u>JT</u>	<u>1/18/15</u>	<u>K-1</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
X. FIXED ASSETS (Continued)

Procedures	Done by	Date	W/P Ref.
F. Determine the carrying amount of assets pledged on notes or other indebtedness. (P)	<u>SS</u>	<u>1/21/15</u>	<u>K-1</u>
G. Determine the cost of any significant fully depreciated assets being carried in the accounts, and if meaningful for disclosure. (P)	<u>N/A</u>	_____	_____
H. Determine that any impairment of value of fixed assets has been properly recognized. (V)	<u>N/A</u>	_____	_____
I. If the entity has adopted SFAS No. 121 and any events or changes in circumstances have occurred indicating that the carrying amount of a long-lived asset may not be recoverable:			
1. Determine if an impairment loss should be recognized. [An impairment loss should be recognized if the carrying amount of an asset exceeds estimated future cash flows (undiscounted and without interest charges).]	<u>N/A</u>	_____	_____
a. Review the estimate of future cash flows for mathematical accuracy and, through discussion with management and review of any supporting documentation, determine that assumptions used are reasonable.	<u>N/A</u>	_____	_____
2. If an impairment loss should be recognized, test the calculation of the loss. [Impairment loss is measured as the amount by which the asset's carrying amount exceeds its fair value.]	<u>N/A</u>	_____	_____
a. Test the fair value used in the calculation by vouching to quoted market prices or by reviewing the valuation technique used.	<u>N/A</u>	_____	_____
b. If the fair value is based on the present value of estimated future cash flows, test for mathematical accuracy and ensure that the assumptions used in the present value calculation, including the discount rate, are reasonable.	<u>N/A</u>	_____	_____
J. Inquire about any significant expansion plans. (P)	<u>SS</u>	<u>1/21/15</u>	<u>K-5</u>
K. Review rental income and expense accounts to determine that leased and subleased assets are properly recorded. (P)	<u>N/A</u>	_____	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
X. FIXED ASSETS (Continued)

Procedures	Done by	Date	W/P Ref.
L. Read client's depreciation schedules for consistency of methods and reasonableness. Test a selection of <u>10</u> computations. Agree schedule to general ledger. (V and P)	<u>SS</u>	<u>1/17/25</u>	<u>K-1</u>
M. Review lease agreements to determine if leases meet criteria for capitalization. (E, R, and V)	<u>SS</u>	<u>1/20/25</u>	<u>K-5</u>
N. Gather and document information for report disclosure and tax return preparation. (P)	<u>N/A</u>	_____	_____
O. Consider and compute any capitalized interest. (V)	<u>N/A</u>	_____	_____
P. Additional procedures: _____ _____ _____	<u>N/A</u>	_____	_____

Prepared by: Sam Sartain Date: 1/21/25
 Reviewed by: John King Date: 1/23/25



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XI. INVESTMENTS AND OTHER ASSETS

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives:

- Existence—To determine that the entity owns the investments at the balance-sheet date and has physical evidence of ownership (securities, receipts from responsible custodians, etc.) (assertions E, C, and R)
- Proper valuation—To determine that the fair value of the investments has been determined as objectively as practicable (assertion V)
- Income recognition—To determine that related income from the investments is properly recorded and received (assertions C, R, and V)
- Restrictions—To determine that restrictions, pledges, or liens on any of the investments and related liabilities are identified and adequately disclosed in the financial statements (assertions E, C, R, and P)
- GAAP conformity—To determine that the financial statement presentation and disclosure of investments and related income (classification; amounts such as cost, share of equity, etc.) is in conformity with GAAP consistently applied (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the Small Business Systems' Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess the impact on tests of balances. (E, C, R, and V)	<u>N/A</u>	_____	_____
B. Obtain schedules of investments and other assets, foot, and agree to the general ledger. (E and C)	<u>SS</u>	<u>1/20/05</u>	<u>F-1</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XI. INVESTMENTS AND OTHER ASSETS *(Continued)*

Procedures	Done by	Date	W/P Ref.
C. Confirm—			
1. Securities held by others. (E and C)	<u>N/A</u>	_____	_____
2. Cash surrender value of life insurance. (V)	<u>SS</u>	<u>1/20/05</u>	<u>F-1</u>
<p>Practice Tip: All confirmation requests should be mailed by the auditor.</p>			
D. For life insurance, reconcile prepaid premiums at the beginning of period, premiums paid, and increase in cash surrender value with life insurance expense. (V)	<u>SS</u>	<u>1/20/05</u>	<u>F-1</u>
E. Review <u>5</u> calculations of investment earnings and related accruals for reasonableness. (V)	<u>N/A</u>	_____	_____
F. Examine documentation supporting investment transactions during the year. (E, R, and V)	_____	_____	_____
G. For investments, determine the current value at the balance-sheet date and at the report date. Challenge carrying amounts. (V)	_____	_____	_____
H. If investments are carried on the equity method—			
1. Determine the company's equity in net assets at year end, earnings (losses), and distributions for the year based on audited information.	_____	_____	_____
2. Obtain a reconciliation of intercompany transactions and balances. Determine reasonableness.	_____	_____	_____
3. Check the computation of amortization of cost over book value. (V)	_____	_____	_____
I. Determine if any investments are pledged or restricted. (P)	_____	_____	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XI. INVESTMENTS AND OTHER ASSETS (Continued)

Procedures	Done by	Date	W/P Ref.
J. For consolidated statements, determine whether the presentation is appropriate. (P)	N/A	_____	_____
K. Additional procedures:			

_____	N/A	_____	_____

Prepared by: Sam Sustain Date: 1/20/15

Reviewed by: John King Date: 1/26/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XII. DEFERRED CHARGES AND INTANGIBLES

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Proper recording—To determine that the balances represent costs that are properly allocable to future periods in conformity with GAAP (assertions E, C, R, and V)
- Support for additions—To determine that additions are adequately supported (assertions E, C, R, and P)
- Appropriateness of amortization—To determine that amortization is determined by a rational and systematic method consistently applied (assertions V and P)
- Recognition of impairment—To determine that any permanent impairment of balance is recognized by writedowns charged to operations (assertions E, C, V, and P)
- Proper classification—To determine that balances and related expenses are properly described and classified in the financial statements (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess the impact on tests of balances. (E, C, R, and V)	SS	12/10/24	AP-3
B. Obtain schedules of deferred charges and intangibles, foot, and reconcile to the general ledger. (E, C, and V)	SS	1/5/24	F-1
C. Examine documentation supporting major transactions during the year. (E, R, and V)	SS	1/5/24	F-2



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XII. DEFERRED CHARGES AND INTANGIBLES (Continued)

Procedures	Done by	Date	W/P Ref.
D. Review capitalization policies and amortization computations as considered necessary. (V)	<u>SS</u>	<u>1/5/15</u>	<u>F-2</u>
E. Determine if there has been any permanent impairment of carrying amounts. (V)	<u>SS</u>	<u>1/5/15</u>	<u>F-2</u>
F. Determine any required disclosures. (P)	<u>SS</u>	<u>1/5/15</u>	<u>F-2</u>
G. Additional procedures:			

_____	<u>WN</u>		

Prepared by: Sam Sotani Date: 1/20/15

Reviewed by: John King Date: 1/26/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XIII. ACCOUNTS PAYABLE

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Existence—To determine that accounts payable represent authorized current obligations (assertions E and C)
- Proper classification—To determine that amounts included in accounts payable are properly classified (assertion P)
- Completeness of obligations—To determine that accounts payable include all significant current obligations (assertions C, R, and V)

Procedures	Done by	Date	W/P Ref.
A. Review results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess the impact on tests of balances. (E, C, R, and V)	SS	1/10/25	
B. Obtain or prepare a list of accounts payable, foot, and reconcile to general ledger. (E and C)	JJ	1/15/25	BB-1
C. Segregate amounts due to officers, employees, stockholders, affiliates, and other related parties. (P)	SS	1/14/25	BB-1
D. Send confirmation requests to <u>12</u> major suppliers and selected other accounts with zero balances. Reconcile and follow up on differences. (E, C, and R)	JJ	1/15/25	

Practice Tip:

All confirmation requests should be mailed by the auditor.



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XIII. ACCOUNTS PAYABLE (Continued)

Procedures	Done by	Date	W/P Ref.
E. Trace large debit balances to credit memos and/or purchase return authorizations. (E, R, and V)	<u>N/A</u>	_____	_____
F. Investigate any disputed items that have not been recorded. (C and R)	<u>JT</u>	<u>1/15/15</u>	_____
G. Consider reclassification and confirmation of material debit balances. (P)	<u>SS</u>	<u>1/18/15</u>	<u>BB-1</u>
H. Additional procedures:			

_____	<u>N/A</u>	_____	_____

Prepared by: Sam Sustain Date: 1/21/15

Reviewed by: John King Date: 1/26/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XIV. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Amount reasonable—To determine that the provision for income taxes is reasonable (assertions E, C, R, and V)
- Amount comparable to amount to be paid—To determine that the liability for accrued income taxes is adequate and not excessive in relation to amounts reasonably expected to be payable (assertions R and V)
- Temporary differences recognized—To determine that deferred income taxes represent the effect of temporary differences (assertions E, C, and V)
- Proper classification—To determine that income tax provisions, accruals, and deferrals are properly described and classified in conformity with GAAP consistently applied (assertion P)
- Liabilities completeness—To determine that expense accounts include costs and expenses applicable to the period (assertions E, C, and P)
- GAAP conformity—To determine that all contingencies and estimated future expenses that should be accrued have been accrued, classified, and described in accordance with GAAP consistently applied (assertions E, C, R, V, and P)

Procedures	Done by	Date	W/P Ref.
A. Review results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess the impact on tests of balances. (E, C, R, and V)	SS	1/10/15	_____
B. Obtain or prepare schedules of all accrued expenses and other liabilities, foot, and agree to the general ledger. (E and C)	JJ	1/16/15	CC-1/13
C. Examine subsequent payments and supporting documents such as tax returns, depository receipts, tax receipts, etc. (E, C, and R)	JJ	1/18/15	CC-1/13



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XIV. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures	Done by	Date	W/P Ref.
D. Obtain copies and amendments for all pension plans. Confirm pension information with actuaries, insurance companies or other trustee. (V and P)	<u>JJ</u>	<u>1/16/85</u>	<u>CC-1/3</u>
E. Obtain a copy of the actuarial report and/or trustee's pension fund report and determine:			
1. Actuarial information agrees with client's records. (V and P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
2. The accounting and funding policies, and employee groups covered by the plans. (P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
3. Adequate provision has been made for current obligations. (V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
4. Pension cost provisions agree. (V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
5. Report disclosure information is available. (P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
F. Obtain and verify disclosure information for pension plans and vouch expense for the period.			
1. For defined contribution plans:			
a. If applicable, obtain copy of trustee's fund report. Consider confirming contents of report with trustee. (E, C, and R)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
b. Ascertain if there have been any adoptions or amendments of plans during the period and obtain copies. Note for financial statement disclosures and: (E, C, R, V, and P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
(1.) Agree expense to minutes, when applicable. (R and V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
(2.) Verify computations, where applicable. (E and C)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
c. Where applicable, test employee data. Test should consist of analytical and other procedures as considered necessary. (E, C, R, and V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XIV. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES *(Continued)*

Procedures	Done by	Date	W/P Ref.
2. For defined benefit plans obtain the following, where applicable:			
a. Copy of actuarial report as of a date no earlier than three months prior to balance-sheet date.	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
b. If applicable, copy of trustee's report.	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
c. Form 5500 for prior year and for current year, if already prepared.	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
d. Actuary's certificate on Schedule B for Form 5500 for prior year and for current year if already prepared.	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
e. Plan document(s).	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
f. Census and plan asset data given to actuary. (E, C, and R)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
3. Consider confirming contents of Trustee report with Trustee. (E, R, and V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
4. Reconcile aggregate census data, such as number of employees covered, compensation, to amounts shown in the actuarial valuation report or if not in the report, consider obtaining confirmation of such data from the actuary. (E and C)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
5. For selected employees, check census data (age, sex, marital status, current pay, term of employment, benefit election, etc.) to payroll records. [Check only those data important to the valuation. If analytical review of data and valuation report appear reasonable, a sample of 15 will generally be acceptable. If not, a sample up to 40 may be required.] (E, C, R, and V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
6. Based on plan documents, make appropriate tests to determine whether all eligible employees are included in the census data provided to the actuary. (E and C)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
7. Reconcile plan assets per the trustee's report to amounts shown in the actuarial valuation report. (E and C)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XIV. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES *(Continued)*

Procedures	Done by	Date	W/P Ref.
8. Ascertain that actuary is professionally qualified. (Membership in the Society of Actuaries, the Conference of Actuaries in Public Practice, American Academy of Actuaries is usually sufficient to indicate that actuary is qualified.) Document conclusions. (V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
9. Inquire as to any relationships between the actuary and the client that would impair independence. Document conclusions. (V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
10. Review the actuary's most recent certificate on Schedule B, Form 5500, and determine the reasons for qualifications expressed, if any. Document conclusions. (V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
11. Ascertain if there have been any adoptions or amendments of plans during the period. Obtain copies of any and note for financial statement disclosure. (E, C, V, and P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
12. Review the latest plan document and compare with key provisions included in the actuarial valuation report. If the report does not include a description of key plan provisions, it may be necessary to confirm the actuary's understanding of such provisions. (E and C)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
13. Vouch the payment of the prior year's accrual to determine that it was paid prior to the filing of the year tax return. (If not paid at the tax return due date, or extended due date, the bank loses its tax deduction.) (E and C)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
14. Trace the authorization for the contribution to the plan to the board of directors' minutes, or obtain the management representation in the representation letter. (R)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
15. Inquire of the client as to any intent to terminate the plan. (E)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
16. Obtain and check disclosure information. (See Financial Statements and Notes Checklist.) (P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XIV. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures	Done by	Date	W/P Ref.
17. If not previously audited, obtain net transition obligation computations and agree amounts to actuarial report, trustees report, or other evidential sources. Recheck compensation. (V and P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
18. Obtain calculation of pension cost for the current period and agree components to actuarial report or trustee's report. (V and P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
19. Determine that a liability is recorded for unfunded accrued pension cost whenever the bank's contribution is less than its related expense or that prepaid pension costs is recorded when the amount funded exceeds the related expenses. (V and P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
20. Determine that an additional liability is recorded equal to the excess, if any, of the accumulated benefit obligation over the fair value of plan assets. (Similar assets are not recorded except when the excess follows a business combination treated as a purchase.) (V and P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
21. Prepare conclusion memo as to whether or not audit objectives have been met and accordingly whether or not the pension and related accounts are fairly stated for inclusion in the (consolidated, if applicable) financial statements in accordance with generally accepted accounting principles. (If not, document details of exception.) (E, C, R, V, and P)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
G. Test the calculations of accrued expenses and examine support as considered necessary. (V)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>
H. Discuss with management any accrued expenses or liabilities at the last balance-sheet date not provided for currently. Be alert for unrecorded liabilities such as warranty costs, legal fees, compensated absences, etc. (C and R)	<u>SS</u>	<u>1/19/85</u>	<u>CC-1/4</u>



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XIV. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures	Done by	Date	W/P Ref.
I. Obtain or prepare an analysis of all balance sheet and earnings statement income tax accounts, foot, and tie to the general ledger. Examine supporting documents and challenge for reasonableness. (C, R, and V)	<u>SS</u>	<u>1/19/05</u>	<u>DD-1/2</u>
J. Review the reconciliation of earnings (losses) per books with the tax returns and the computation of current and deferred income tax expense and liabilities. Determine that deferred taxes have been accounted for as required by GAAP. (V)	<u>SS</u>	<u>1/19/05</u>	<u>DD-3</u>
K. Determine any reconciliations between pretax earnings and income tax expense that should be disclosed. (P)	<u>SS</u>	<u>1/19/05</u>	_____
L. Investigate the status of any unsettled prior years' tax matters. Determine the impact of prior years' settlements on the current year. (C and V)	<u>SS</u>	<u>1/19/05</u>	_____
M. Review a schedule of net operating loss carryovers and unused tax credits for propriety. (P)	<u>SS</u>	<u>1/19/05</u>	_____
N. Obtain a tax department review of the income tax working papers. (V and P)	<u>N/A</u>	_____	_____
O. Obtain the following income tax disclosure information:			
1. Classification of deferred taxes on the balance sheet.	<u>SS</u>	<u>1/19/05</u>	<u>DD-3</u>
2. Composition of provision, that is, amounts of taxes currently payable and deferred.	<u>SS</u>	<u>1/19/05</u>	<u>DD-3</u>
3. Prior-period adjustment allocations.	<u>SS</u>	<u>1/19/05</u>	<u>DD-3</u>
4. Tax benefits of loss and credit carryovers. (P)	<u>SS</u>	<u>1/19/05</u>	<u>DD-3</u>
P. Compute, or obtain and test the client's computation of, deferred tax assets and liabilities to determine conformance with SFAS No. 109.	<u>SS</u>	<u>1/19/05</u>	_____
Q. For deferred tax assets, determine the likelihood that all or part of the recorded amount will not be realized.	<u>SS</u>	<u>1/19/05</u>	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XIV. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures	Done by	Date	W/P Ref.
R. If it is determined that it is more likely than not that all or part of the deferred tax asset will not be realized, evaluate the adequacy of the valuation allowance account by performing the following:			
1. Review and test the process used by management to develop the estimate, or develop an independent expectation of the estimate, to corroborate the reasonableness of management's estimate.	SS	1/19/15	
2. Determine whether any subsequent events or transactions have occurred prior to the completion of field work that could affect the adequacy of the valuation allowance.	SS	1/19/15	
S. Consider additional tax liabilities to any states in which the client does business. (C and R)	SS	1/19/15	DD-3
T. Additional procedures:			

_____	N/A		

Prepared by: Sam Sartain Date: 1/19/15

Reviewed by: John King Date: 1/22/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XV. NOTES PAYABLE AND LONG-TERM DEBT

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Existence—To determine that notes payable and long-term debt are authorized, properly classified, and described in the financial statements (assertions R and P)
- Recording in the proper period—To determine that liabilities are recorded in the proper period at the correct amounts (assertions E, C, and V)
- Recognition of expense—To determine that related interest expense (including discount or premium) is accounted for in conformity with GAAP consistently applied (assertions C and P)
- Adequacy of disclosure—To determine that the financial statements include adequate disclosure of restrictive covenants of loan agreements, pledged assets, etc. (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess the impact on tests of balances. (E, C, R, and V)	SS	1/16/15	_____
B. Obtain or prepare a schedule of notes and related interest expense showing beginning balances, additions, payments, ending balances, and all terms of borrowing and payment. Recompute the mathematical accuracy of the schedule and reconcile to the general ledger. (E and C)	JJ	1/16/15	_____
C. Obtain or prepare copies of all notes and related agreements for the permanent file. (E, R, and V)	JJ	1/16/15	_____
D. Examine notes canceled during the period or related evidence of payment. (C and R)	JJ	1/16/15	_____
E. Confirm significant balances outstanding at any time during the period. (E, R, and V)	SS	1/16/15	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XV. NOTES PAYABLE AND LONG-TERM DEBT (Continued)

Procedures	Done by	Date	W/P Ref.
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Practice Tip:
All confirmation requests should be mailed by the auditor.

- | | | | |
|--|-----|---------|-------|
| F. Examine loan agreements and review compliance with restrictive covenants. (P) | SS | 1/19/15 | _____ |
| G. Determine if any assets are subject to lien and obtain carrying amounts for disclosure. (P) | SS | 1/19/15 | _____ |
| H. Examine notes for any guarantees. Be alert for related-party guarantees. All guarantee relationships should be disclosed. (P) | SS | 1/19/15 | _____ |
| I. Separate short-term notes and the current portion of long-term debt for report classification. Categorize by type of lender (related-party, banks, loan company, etc.). Prepare or obtain schedule of five-year maturities for all long-term obligations. (P) | SS | 1/19/15 | AA-1 |
| J. Consider the need to impute interest on noninterest-bearing notes. (V) | N/A | _____ | _____ |
| K. Review the computation of, or recompute, balances in capitalized lease obligations accounts. Gather information for financial statement disclosure. (V and P) | N/A | _____ | _____ |
| L. Additional procedures:

_____ | N/A | _____ | _____ |

Prepared by: Sam Sarani Date: 1/19/15
 Reviewed by: John King Date: 1/21/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XVI. CONTINGENT LIABILITIES, CONTRACTS, AND COMMITMENTS

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Contingencies exist—To determine the existence of any contingencies arising from litigation, claims, and assessments that affect the financial statements or disclosures (assertions E, C, R, V, and P)
- Contracts exist—To determine the existence of any contracts affecting the financial statements or disclosures (assertions E, C, R, V, and P)
- Commitments exist—To determine the existence of any commitments affecting the financial statements or disclosures (assertions E, C, R, V, and P)
- Proper recording and disclosure—To determine that the financial statements include proper accruals and/or disclosure of the contingencies and commitments (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the Small Business System's Walk-Through Documentation Form, and Small Business Analytical Procedures Program, and assess impact on tests of balances. (E, C, R, and V)	SS	1/13/25	_____
B. Discuss with management its description and evaluation of possible and existing litigation, claims, and assessments, including violations of laws. (E, C, R, V, and P)	SS	1/21/25	_____
C. Inquire of management as to agreements for anticipated future expenditures such as purchase orders, leases, employee benefit plans, plant expansion or improvement arrangements, etc. (E, C, R, and P)	SS	1/21/25	_____
D. Examine all available documents concerning these matters. (E, C, R, V, and P)	SS	1/21/25	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XVI. CONTINGENT LIABILITIES, CONTRACTS, AND COMMITMENTS *(Continued)*

Procedures	Done by	Date	W/P Ref.
E. Request a letter from the client's attorneys regarding contingencies, commitments, and other matters. Investigate reasons for any changes in legal counsel. (C, R, V, and P)	<u>SS</u>	<u>1/10/05</u>	_____
<p>Practice Tip:</p> <p>All confirmation requests should be mailed by the auditor.</p>			
F. Review minutes of directors' meetings and discuss all pertinent items with management. Summarize or copy, and agree to applicable working papers. (C, R, V, and P)	<u>SS</u>	<u>1/10/05</u>	_____
G. Analyze legal expense for any undisclosed matters. (C, R, V, and P)	<u>JJ</u>	<u>1/21/05</u>	_____
H. Obtain a schedule of any purchase contracts or commitments. (C, R, V, and P)	<u>N/A</u>	_____	_____
I. Determine whether the entity has any commitments with off-balance-sheet risk (i.e., financial guarantees and letters of credit at floating rates). For any such commitments, complete steps G.1 through 5 of Section VIII, Investment Securities.	_____	_____	_____
J. Investigate any product warranties. (V and P)	<u>N/A</u>	_____	_____
K. Obtain or prepare a schedule of open letters of credit. (P)	<u>N/A</u>	_____	_____
L. If considered necessary, obtain Uniform Commercial Code information and agree to notes payable and debt working papers. (P)	<u>N/A</u>	_____	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XVI. CONTINGENT LIABILITIES, CONTRACTS, AND COMMITMENTS *(Continued)*

Procedures	Done by	Date	W/P Ref.
M. Additional procedures:			

_____	N/A		

Prepared by: Sam Sartin Date: 1/21/25

Reviewed by: John King Date: 1/26/25



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XVII. STOCKHOLDERS' EQUITY

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Proper authorization and classification—To determine that all transactions and commitments (options, warrants, rights, etc.) are properly authorized and classified (assertions E, C, R, V, and P)
- Proper recognition and cutoff—To determine that all transactions and commitments are recorded at correct amounts in the proper period (assertions E, C, and P)
- GAAP conformity—To determine that all transactions and balances are presented in the financial statements in conformity with GAAP consistently applied and accompanied by adequate disclosures (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program, and assess impact on tests of balances. (E, C, R, and V)	SS	1/11/25	---
B. Update or obtain a listing of all capital stock authorized, issued, and outstanding; treasury stock; and all equity accounts transactions during the year. Foot and tie to the general ledger. (E, C, R, V, and P)	SS	1/11/25	SS-1
C. Examine minutes, bylaws, articles of incorporation, or other documents in support of transactions. (E, R, V, and P)	SS	1/11/25	SS-1



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XVII. STOCKHOLDERS' EQUITY (Continued)

Procedures	Done by	Date	W/P Ref.
D. Verify outstanding stock by agreeing open stubs in the stock certificate book to the listing or confirm with the transfer agent the total issued shares and the total shares issued in the company's name. Determine that surrendered certificates have been canceled and accounted for. (E, C, R, and P)	<u>SS</u>	<u>1/11/05</u>	<u>SS-1</u>
<p>Practice Tip:</p> <p>All confirmation requests should be mailed by the auditor.</p>			
E. Inspect or confirm treasury stock certificates. (C and R)	<u>N/A</u>	_____	_____
F. Determine and document any restrictions on equity accounts. (P)	<u>N/A</u>	_____	_____
G. Inquire about any options, warrants, and stock purchase plans at the balance-sheet date. (P)	<u>N/A</u>	_____	_____
H. Obtain information for each class of stock concerning preferences, dividend requirements and arrearages, redemption or conversion rights, and call provisions for disclosure. (P)	<u>N/A</u>	_____	_____
I. Trace the opening balance of each equity account to the beginning balance sheet. (E)	<u>SS</u>	<u>1/11/05</u>	<u>SS-1</u>
J. Determine that declared and unpaid dividends are properly recorded. Compare paid dividends to directors' minutes. (E, C, R, V, and P)	<u>N/A</u>	_____	_____
K. Examine supporting documents and authorizations for all other transactions in retained earnings for appropriateness. (E, V, and P)	<u>N/A</u>	_____	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XVII. STOCKHOLDERS' EQUITY (Continued)

Procedures	Done by	Date	W/P Ref.
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L. Additional procedures:

_____	N/A		

Prepared by: Sam Sartain Date: 1/11/05

Reviewed by: John King Date: 1/20/05



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XVIII. RELATED-PARTY TRANSACTIONS

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Proper recognition—To identify related parties and related-party transactions (assertion E and C)
- Proper recording—To determine that the substance of such transactions is reflected in the accounts (assertions C, R, and V)
- Proper disclosure—To determine that all necessary information is obtained for footnote disclosure (assertions C and P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program, and assess impact on tests of balances. (E, C, R, and V)	<u>SS</u>	<u>1/3/25</u>	_____
B. Make inquiries of management about related parties, obtain related-party confirmations if applicable, and inquire about any recorded or unrecorded transactions during the year. (E, C, R, V, and P)	<u>SS</u>	<u>11/10/24</u>	_____
<p>Practice Tip:</p> <p>All confirmation requests should be mailed by the auditor.</p>			
C. Obtain names of stockholders and directors for evidence of related-party transactions. (E and C)	<u>SS</u>	<u>11/5/24</u>	_____
D. Review last year's working papers for evidence of related-party transactions. (E and C)	<u>SS</u>	<u>11/10/24</u>	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XVIII. RELATED-PARTY TRANSACTIONS (Continued)

Procedures	Done by	Date	W/P Ref.
E. Investigate transactions with major customers, suppliers, and lenders for undisclosed relationships. (E and C)	<u>SS</u>	<u>11/10/24</u>	_____
F. Review minutes of stockholders' and directors' meetings for evidence of related parties. (E and C)	<u>SS</u>	<u>11/10/24</u>	_____
G. Be alert for potential related-party transactions while examining confirmations of receivables and payables, unusual transactions, and attorneys' letters. (E and C)	<u>SS</u>	<u>11/10/24</u>	_____
H. Obtain a list of major customer sales during the year and amounts of receivables at year end. Foot and agree to detail client records. Consider disclosure. (E, C, and P)	<u>SS</u>	<u>11/10/24</u>	_____
I. Examine supporting documents of significant related-party transactions to determine—			
1. Business purpose (V and P)	<u>SS</u>	<u>11/10/24</u>	_____
2. Board of directors' approval (P)	<u>SS</u>	<u>11/10/24</u>	_____
3. Reasonableness and consistency of amounts to be disclosed (V and P)	<u>SS</u>	<u>11/10/24</u>	_____
4. Financial capabilities of related parties (V and P)	<u>SS</u>	<u>11/10/24</u>	_____
J. Additional procedures:			

_____	<u>N/A</u>		_____

Prepared by: Sam Sartin Date: 12/20/24
 Reviewed by: John King Date: 12/21/24



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XIX. SALES

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Proper recognition—To determine that revenue transactions represent consideration applicable to goods shipped and/or completed services rendered to customers (or clients) in the normal course of business during the period (assertions E, R, V, and P)
- Realization of revenue—To determine that revenue transactions have resulted in collections or bona fide receivables (assertions E and C)
- Recording of revenue—To determine that all revenues earned during the period are recorded and included in the financial statements (assertions E, C, and P)
- Proper classification—To determine that revenues are properly classified and described in the financial statements and accompanied by adequate disclosure (assertions V and P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program and assess impact on tests of balances. (E, C, R, and V)	SS	1/10/X5	_____
B. Review the source journal for any large or unusual sales transactions, especially near year end. Examine invoice and shipping document. (E, R, and V)	SS	1/11/X5	_____
C. Randomly select <u>10</u> shipping orders prepared at various times during the year. Obtain related sales invoice, and trace to the sales journal. (C)	JJ	1/15/X5	10-1
D. Determine proper income recognition when the right of return exists. (E, R, and V)	SS	1/11/X5	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XIX. SALES (Continued)

Procedures	Done by	Date	W/P Ref.
E. Determine that any product financing arrangements are accounted for properly. (E, R, V, and P)	SS	1/18/05	
F. Determine that sales of extended warranty and product maintenance contracts are accounted for properly. (E, R, and V)	SS	1/18/05	
G. Determine that bill and hold sales are accounted for properly. (E, R, and V)	SS	1/18/05	

Practice Tip:
If the client has offices in different states, be sure to itemize sales to aid in allocation for income tax calculations and returns.

H. Additional procedures:

N/A _____

Prepared by: Sam Sustain Date: 1/18/05
Reviewed by: John King Date: 1/20/05



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XX. COST OF GOODS SOLD

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Proper recording—To determine that costs of goods sold are properly allocable to the period (assertions E, C, and V)
- Proper recognition—To determine that all costs have been recognized (assertions E, C, R, and V)
- GAAP conformity—To determine that costs of goods sold are recorded in conformity with GAAP consistently applied (assertion P)
- Proper classification—To determine that costs of goods sold are appropriately classified and described in the statement of income (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program, and assess impact on tests of balances. (E, C, R, and V)	SS	1/3/15	_____
B. If major, unexplained variances exist, scan entries in source journals and investigate timing, size and method of recording unusual items. Discuss findings with management. (E, C, V, and P)	N/A	_____	_____
C. Calculate gross profit percentages by product line. Compare them to prior year amounts and investigate any unusual fluctuations. (E, C, R, and V)	SS	1/3/15	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XX. COST OF GOODS SOLD (Continued)

Procedures	Done by	Date	W/P Ref.
D. Additional procedures:			

_____	N/A		

Prepared by: Sam Sartain Date: 11/6/85

Reviewed by: John King Date: 11/5/85



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XXI. OTHER REVENUES AND EXPENSES

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives:

- Proper recording—To determine that other revenues and expenses are properly allocable to the period (assertions E, C, and V)
- Proper recognition—To determine that other revenue and expenses have been recognized (assertions E, C, R, and V)
- GAAP conformity—To determine that the income statement is prepared in conformity with GAAP consistently applied (assertion P)
- Proper classification—To determine that other revenues and expenses are appropriately classified and described in the income statement (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Programs and assess the impact on tests of balances. (E, C, R, and V)	<u>S</u>	<u>12/15</u>	<u> </u>
B. Obtain or prepare schedules of other revenues and expenses, foot, tie to general ledger, and investigate large or unusual items. (E, V, and P)	<u>S</u>	<u>12/15</u>	<u>50</u>

Practice Tip:

Be alert to potential mispostings in other revenue and expense accounts. Clients often post tax payments to miscellaneous expense accounts because there is no general ledger account set up for the payments.



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XXI. OTHER REVENUES AND EXPENSES (Continued)

Procedures	Done by	Date	W/P Ref.
C. Vouch as considered necessary. (E, C, and V)	SS	1/20/15	50-1
D. Additional procedures:			

_____	NA		

Prepared by: Sam Sustain Date: 1/26/15

Reviewed by: John King Date: 1/31/15



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XXII. EXPENSE ACCOUNT ANALYSIS AND VOUCHING

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Proper recording—To determine that reported expenses include costs that are properly allocable to the period and are properly matched with revenues (assertions E, C, and V)
- Proper recognition—To determine that all costs and expenses (including losses) that should be recognized have been recognized (assertions E, C, R, and V)
- Proper classification—To determine that extraordinary items have been properly classified and disclosed (assertions E and P)
- GAAP conformity—To determine that the income statement is prepared in conformity with GAAP consistently applied (assertions V and P)
- Proper classification—To determine that costs and expenses are appropriately classified and described in the income statement (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the results of the applicable sections of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program, and assess the impact on tests of balances. (E, C, R, and V)	<u>JS</u>	<u>12/15</u>	_____
B. Scan source journals for large or unusual transactions and determine that they are properly recorded. (E, C, R, V, and P)	<u>JS</u>	<u>12/15</u>	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XXII. EXPENSE ACCOUNT ANALYSIS AND VOUCHING *(Continued)*

Procedures	Done by	Date	W/P Ref.
C. Obtain, foot, and tie to general ledger, detailed analyses of charges and credits to expense accounts for the following:			
1. Officers' salaries and bonuses. Determine board of directors' authorization.	<u>SS</u>	<u>1/28/15</u>	<u>70-1</u>
2. Officers' expenses (for tax return).	<u>SS</u>	<u>1/28/15</u>	_____
3. Contributions (tax-deductible).	<u>SS</u>	<u>1/28/15</u>	_____
4. Taxes.	<u>SS</u>	<u>1/28/15</u>	_____
5. Travel and entertainment expenses. Look for adequate documentation.	<u>SS</u>	<u>1/28/15</u>	_____
6. Property tax expense (for unrecorded property).	<u>SS</u>	<u>1/28/15</u>	_____
7. Miscellaneous expense. Look for large or unusual items.	<u>SS</u>	<u>1/28/15</u>	_____
8. Other accounts:			

_____	<u>N/A</u>		

(E, C, R, V, and P)

Practice Tip:

An analysis of trial balance expense accounts can prove to be a valuable tool for both the audit and any tax engagements you have with the client. At tax time it's always beneficial to have the details of expenses required to prepare the client's tax return. It will always save you time (and money) to prepare these schedules during the audit engagement.



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XXII. EXPENSE ACCOUNT ANALYSIS AND VOUCHING *(Continued)*

Procedures	Done by	Date	W/P Ref.
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D. As considered necessary, obtain supporting vendor invoices or other documentation to determine that charges or credits to the accounts above apply to the company and are recorded at the proper amount in the proper period. (E, C, R, and V)	NR		
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E. Additional procedures:			

_____	NR		

Prepared by: Sam Sustain Date: 12/15/05

Reviewed by: John King Date: 1/30/06



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XXIII. PAYROLL

Financial Statement Assertions

- Existence or occurrence (E)
- Completeness (C)
- Rights and obligations (R)
- Valuation or allocation (V)
- Presentation and disclosure (P)

Objectives

- Proper recording—To determine that reported payroll expenses are properly allocable to the period (assertions E, C, and V)
- Proper recognition—To determine that all payroll expenses which should be recognized have been recognized (assertions E, C, R, and V)
- GAAP conformity—To determine that the income statement is prepared in conformity with GAAP consistently applied (assertion P)
- Proper classification—To determine that payroll expenses are appropriately classified and described in the income statement (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Review the applicable section of the Small Business System's Walk-Through Documentation Form and Small Business Analytical Procedures Program, and assess the impact on tests of balances. (E, C, R, and V)	SS	1/10/25	---
B. Scan source journals for unusual transactions to determine that they are recorded properly. (E, C, R, and V)	SS	1/10/25	---
C. Prepare a schedule of monthly payroll costs by department. (E, C, R, V, and P)	JTJ	1/10/25	70-2

Practice Tip:

If the client has offices in different states, be sure to itemize payroll expense to aid in allocation for income tax calculations and returns.



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM
XXIII. PAYROLL (Continued)

Procedures	Done by	Date	W/P Ref.
D. Compare schedules to prior periods, budget, and production records and investigate significant fluctuations. (E, C, R, and V)	<u>JJ</u>	<u>1/10/05</u>	<u>70-2</u>
E. Reconcile gross wages on payroll tax returns to general ledger. (E, C, R, and V)	<u>JJ</u>	<u>1/10/05</u>	<u>70-2</u>
F. Additional procedures:			

_____	<u>N/A</u>		

Prepared by: Sam Sustain Date: 1/30/05

Reviewed by: John King Date: 1/30/05



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XXIV. RISK AND UNCERTAINTIES

Financial Statement Assertion

Presentation and disclosure (P)

Objective

- GAAP conformity—To determine that disclosure of certain significant estimates and certain concentrations is in conformity with GAAP consistently applied. (assertion P)

Procedures	Done by	Date	W/P Ref.
A. Obtain or prepare a listing of any estimates used in determining the carrying values of assets and liabilities and gain and loss contingencies that are sensitive to change. Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate. (P)	<u>SS</u>	<u>1/15/15</u>	<u>R-1</u>
B. Consider whether it is at least reasonably possible that a material change in the estimate will occur in the near term. (P)	<u>SS</u>	<u>1/15/15</u>	<u>R-1</u>
C. If such a situation is identified, review support for the calculation of the effect of the change. (P)	<u>N/A</u>	_____	_____
D. Obtain or prepare a listing of the following types of concentrations, if any, that existed at the balance-sheet date and that make the entity vulnerable to risk of near-term severe impact (severe impact is a higher threshold than materiality, but less than catastrophic). Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate:			
• volume of business transacted with a particular customer, supplier, or lender (P)	<u>SS</u>	<u>1/15/15</u>	<u>R-1</u>
• revenues from particular products or services (P)	<u>N/A</u>	_____	_____
• available sources of supply of materials, labor or services, or of licenses or other rights used in operations (P)	<u>N/A</u>	_____	_____
• market or geographic area in which the entity conducts its operations (P)	<u>N/A</u>	_____	_____



SMALL BUSINESS TESTS OF BALANCES AUDIT PROGRAM

XXIV. RISK AND UNCERTAINTIES

Procedures	Done by	Date	W/P Ref.
E. Determine whether it is at least reasonably possible that an event will occur in the near term that would cause the severe impact. (P)	<u>SS</u>	<u>1/15/05</u>	<u>R-1</u>
F. Determine whether disclosures required by SOP 94-6 are completely and accurately included in the financial statements. (Refer to the Small Business Audit Disclosure and Reporting Checklist in Chapter 14.) (P)	<u>SS</u>	<u>1/15/05</u>	<u>R-1</u>
G. Additional procedures:			

_____	<u>NA</u>		

Prepared by: Sam Sattari Date: 1/30/05

Reviewed by: John King Date: 1/30/05



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