

**superfast**CPA

# AUD REVIEW NOTES

2026

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## How to Use These Review Notes:

The best way to use these review notes is in the following ways:

1. Read from these review notes as a part of your mini sessions each day. Switch between reading a few pages of these notes and taking quizzes on the SuperfastCPA app. Doing this multiple times a day will get you through the notes at least a couple or more times throughout your study process.
2. When doing your 2-hour main study session each day, before starting a new section or topic, find that topic in these review notes and read through it to get a base understanding of what you are about to study. This doesn't need to be a deep read, just a primer to get you started.
3. Read through these review notes all the way through at least 2-3 times in the two days of your 48-hour cram session before your exam.

### AICPA Blueprints and “Representative Tasks”

We have made these review notes to mirror the AICPA blueprints. You will notice that each section says one of the following: Remembering and Understanding, Application, Analysis, or Evaluation (Evaluation will only be on the Audit exam).

- If a section says Remembering and Understanding, that means it will almost certainly be tested as a Multiple Choice Question if it is tested.
- If a section says Application, that means it could be tested as either a Multiple Choice Question or a Simulation.
- If a section says either Analysis or Evaluation (for Audit only), it will almost certainly be tested as a Simulation.

# Area I – Ethics, Professional Responsibilities and General Principles

## A. Ethics, Independence and Professional Responsibilities

### 1. AICPA Code of Professional Conduct

*Remembering and Understanding: Understand the principles, rules and interpretations included in the AICPA Code of Professional Conduct.*

The Code is the foundation of ethical behavior for CPAs in both public practice and business, comprising principles, rules, and interpretations which guide CPAs in the conduct of their professional responsibilities.

**The AICPA Code of Professional Conduct includes:**

#### **Principles:**

These are ideal standards of ethical conduct stated in philosophical terms and serve as a foundation for the Rules.

- **Responsibilities:** In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
- **The Public Interest:** Members should act in a manner that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
- **Integrity:** To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

- **Objectivity and Independence:** Members should be objective, independent, and free of conflicts of interest in discharging professional responsibilities. Independence is specifically required when performing auditing and other attestation services.
- **Due Care:** Members should observe both the technical and ethical standards of the profession, strive continually to improve competence and quality of services, and discharge professional responsibility to the best of their ability.
- **Scope and Nature of Services:** Members in practice should observe the Principles of the Code in determining the scope and nature of services to be provided.

### Rules:

These are the minimum standards of ethical conduct stated as specific rules and are enforceable.

- **Independence:** Members must be independent in fact and appearance when providing auditing and other attestation services.
- **Integrity and Objectivity:** In the performance of any professional service, members must maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate their judgment to others.
- **General Standards:** Members must comply with the following standards and with any interpretations thereof by bodies designated by the AICPA Council:
  - Professional competence
  - Due professional care
  - Planning and supervision



- Sufficient relevant data
- **Compliance with Standards:** Members must comply with applicable technical standards.
- **Accounting Principles:** Members must ensure that financial statements or other financial data they prepare or report on reflect the appropriate accounting principles.
- **Confidential Client Information:** Members must not disclose any confidential client information without the specific consent of the client.
- **Contingent Fees:** Certain contingent fee arrangements are prohibited for members performing attestation services.
- **Acts Discreditable:** Members should not commit an act discreditable to the profession.
- **Advertising and Other Forms of Solicitation:** Advertising or other forms of solicitation that are false, misleading, or deceptive are prohibited.
- **Commissions and Referral Fees:** Members are prohibited from accepting commissions or referral fees for recommending the products or services of others in certain circumstances.
- **Form of Organization and Name:** A member's firm may practice in any form permitted by state law or regulation, and the firm's name should not be misleading.

### **Interpretations and Rulings:**

Interpretations are published explanations and answers to questions regarding rules of conduct, which are also enforceable. Rulings are not enforceable but provide guidelines to members for the conduct of their practice.

*Application: Apply the principles, rules and interpretations included in the AICPA Code of Professional Conduct to situations (e.g. maintaining integrity and objectivity and compliance with standards, maintaining the confidentiality of client information when using automated or third-party tools and techniques including artificial intelligence).*

### **Example 1: Independence Issue**

- *Scenario: A CPA is auditing a long-time client. The client's CEO is the CPA's close friend and former college roommate.*
- *Application: The CPA faces a familiarity threat to independence. The CPA should evaluate the significance of this threat. Given the close personal relationship, the threat might be significant.*
- *Action: The CPA should either:*
  - *Assign a different lead auditor who does not have a personal relationship with the CEO, or*
  - *If the CPA is a sole practitioner, they may need to resign from the engagement and suggest the client engage a different firm to preserve audit independence.*
- *Code Reference: This situation would be relevant to the "Independence" rule and the interpretation related to familiarity threats.*

### **Example 2: Potential Self-Interest Threat**

- *Scenario: A CPA firm provides consulting services on a contingent fee basis to a non-audit client. The same client now requests audit services.*
- *Application: This creates a self-interest threat because the contingent fee could influence the CPA firm's objectivity.*
- *Action: The CPA firm should:*

- *Terminate the contingent fee arrangement before accepting the audit engagement, or*
- *Decline the audit engagement to maintain compliance with the Code.*
- *Code Reference: The scenario relates to the "Contingent Fees" and "Independence" rules.*

### **Example 3: Confidentiality Concern**

- *Scenario: A CPA in public practice learns confidential information about a client's pending legal action that could impact the client's financial statements while performing an audit.*
- *Application: The CPA has a duty under the "Confidential Client Information" rule not to disclose this information without the client's consent.*
- *Action: The CPA should:*
  - *Keep the information confidential unless they have a legal obligation to disclose it, such as a subpoena.*
  - *Discuss with the client the need to disclose this information in the financial statements, if material.*
- *Code Reference: This is a matter of "Confidential Client Information" and possibly "Integrity and Objectivity" if the legal action affects the audit.*

### **Example 4: Integrity and Objectivity Issue**

- *Scenario: A CPA working on an audit engagement discovers that the client's management wants to omit certain required disclosures to present a more favorable financial position.*

- *Application: This situation challenges the CPA's integrity and objectivity, as omitting disclosures would mislead users of the financial statements.*
- *Action: The CPA should inform management of the requirement to include the disclosures. If management refuses, the CPA should consider withdrawing from the engagement to maintain integrity and objectivity.*
- *Code Reference: This issue relates to the "Integrity and Objectivity" rule, which requires honesty and impartiality in all professional services.*

#### **Example 5: Self-Review Threat**

- *Scenario: A CPA firm has been asked to audit the financial statements of a company after providing bookkeeping services, including preparing financial statements for that same company.*
- *Application: This situation poses a self-review threat to independence.*
- *Action: The CPA firm must assess whether any safeguards can be applied, such as having a separate team conduct the audit. If safeguards cannot adequately reduce the threat, the firm may have to decline the audit engagement.*
- *Code Reference: This falls under the "Independence" rule regarding self-review threats.*

#### **Example 6: Compliance with Standards**

- *Scenario: A CPA preparing financial statements for a client is asked to follow a modified accounting method that does not comply with GAAP.*

- *Application: Compliance with standards requires that financial statements follow applicable accounting principles. The CPA must ensure that GAAP is followed in preparing financial statements unless there is a valid alternative reporting framework with proper disclosures.*
- *Action: The CPA should inform the client that non-GAAP methods cannot be used if GAAP is the agreed-upon framework. If the client insists, the CPA should decline the engagement to avoid noncompliance.*

### **Example 7: Using AI-Based Data Analysis Tools**

- *Scenario: A CPA firm uses an AI-based tool to analyze large datasets for client audits. The tool is hosted by a third-party vendor who has access to the client data used in the analysis.*
- *Application: Since the CPA firm is responsible for client confidentiality, it must ensure the third-party vendor does not misuse or improperly share client data.*
- *Action: The CPA firm should have a confidentiality agreement with the AI provider and confirm that all data handling practices adhere to privacy requirements. If proper protections are not in place, the CPA should refrain from using the tool.*
- *Code Reference: This scenario is relevant to the "Confidential Client Information" rule, requiring the CPA to ensure that AI vendors also maintain confidentiality.*

### **Example 8: Data Sharing for Machine Learning Insights**

- *Scenario: A CPA wants to use machine learning models that require aggregated data from multiple clients to provide deeper insights into industry trends.*
- *Application: The CPA must avoid sharing any client-identifiable data unless they have explicit consent from each client or use anonymized data to prevent confidentiality breaches.*
- *Action: The CPA should anonymize all client information or obtain explicit client approval before using it for analysis in the machine learning model.*
- *Code Reference: This relates to "Confidential Client Information" and reinforces the need for safeguarding identifiable client data even when using it in aggregated, analytical models.*

*Application: Apply the Conceptual Framework for Members in Public Practice and Members in Business included in the AICPA Code of Professional Conduct to situations that could present threats to compliance with the rules included in the Code.*

The Conceptual Framework is a critical component of the AICPA Code of Professional Conduct that helps both public practitioners and members in business to identify, evaluate, and respond to threats to compliance with the Code.

## **For Members in Public Practice**

### **Conceptual Framework Steps:**

- Identify threats: Members must be aware of situations that could pose threats to compliance.
- Evaluate the significance of the threats: Consider whether threats are at an acceptable level.
- Apply safeguards: Implement measures to eliminate the threats or reduce them to an acceptable level.

### **Example:**

*A CPA firm is asked to perform an audit for a client who is also a significant investor in the CPA firm.*

- *Identify Threats: There's an obvious self-interest threat because the client's investment could influence the firm's independence.*
- *Evaluate Significance: Given the dual role as a client and an investor, the threat to independence is significant and could lead to a reasonable perception that the firm's objectivity might be compromised.*
- *Apply Safeguards: Potential safeguards could include removing the client's influence over the audit*



*engagement, such as by having them divest their interest in the firm, or the CPA firm may have to resign from the audit engagement if adequate safeguards cannot be applied to reduce the threat to an acceptable level.*

## **For Members in Business**

### **Conceptual Framework Steps:**

- Identify threats: Recognize personal, external, and organizational pressures or interests that may conflict with adherence to the Code.
- Evaluate the significance of the threats: Consider the likelihood and potential impact of the threats on the member's ability to comply with the Code.
- Apply safeguards: Introduce measures within the organization to mitigate identified threats.

### **Example:**

*A CPA who is the CFO of a company is under pressure from the CEO to aggressively recognize revenue to meet financial targets.*

- *Identify Threats: This situation presents an intimidation threat from the CEO, which could lead the CFO to compromise ethical principles to conform to the CEO's wishes.*
- *Evaluate Significance: The threat is significant as it could impact the fair presentation of the financial statements and the CFO's ability to act with integrity and objectivity.*



- *Apply Safeguards: The CFO might discuss the issue with the audit committee, seek advice from an external ethics advisor, or implement stricter internal controls over revenue recognition to ensure that they act in accordance with the Code.*

### **Applying the Framework:**

In both public practice and business, members must continuously apply the conceptual framework to maintain professional ethics.

The following are steps to apply the framework:

- **Continuous Professional Development:** Members should stay informed about the ethical requirements and changes in the Code.
- **Documentation:** Encourage documenting all steps taken when applying the framework, including identifying threats, evaluating their significance, and the safeguards applied.
- **Professional Consultation:** Sometimes it's necessary to consult with colleagues or legal advisors to gain perspective on the ethical dilemma.
- **Regular Review:** Implement a regular review process for policies and procedures related to the Code to ensure ongoing compliance.

*Application: Apply the Conceptual Framework for Independence included in the AICPA Code of Professional Conduct to situations that could present threats to compliance with the rules included in the Code.*

The Conceptual Framework for Independence is specifically designed to help CPAs identify, evaluate, and address threats to independence and thereby maintain compliance with the AICPA Code of Professional Conduct.

**The steps in applying the Conceptual Framework for Independence are:**

- **Identify Threats:** Recognize circumstances that might impair independence.
- **Evaluate Threats:** Determine whether threats are at an acceptable level.
- **Apply Safeguards:** If necessary, apply safeguards to eliminate the threats or reduce them to an acceptable level.
- **Continually Reassess:** Regularly review and reassess the threats and safeguards as circumstances change over time.

**Example 1: Financial Interest in a Client**

*Scenario: A CPA holds stocks in a client's company for which they also provide audit services.*

- *Identify Threats: Ownership of stock in an audit client presents a self-interest threat to independence.*
- *Evaluate Threats: Any direct financial interest is generally considered to be a significant threat to independence.*

- *Apply Safeguards: To mitigate this threat, the CPA must dispose of the financial interest before commencing the audit engagement.*
- *Continually Reassess: The CPA should have a system in place to periodically check for any financial interests that may arise in the future with audit clients.*

### **Example 2: Close Family Member Employed by the Client**

*Scenario: A CPA's sibling has been hired as the CFO of an audit client.*

- *Identify Threats: The employment of a close family member in a key position with the client represents a familiarity threat.*
- *Evaluate Threats: The threat is significant, especially if the sibling could influence the financial statements.*
- *Apply Safeguards: Potential safeguards include having the CPA removed from the audit engagement, or if the firm is small and this is not possible, consider not providing the audit service.*
- *Continually Reassess: The CPA should have discussions with firm leadership and, if applicable, the audit committee of the client about the employment of family members and any new threats that may arise.*

### **Example 3: Recent Employment with the Client**

*Scenario: A CPA has joined an audit firm and is assigned to an audit of a company where they were recently employed in a management position.*

- *Identify Threats: This creates a self-review threat as the CPA may be auditing areas they once managed.*
- *Evaluate Threats: Such a threat is typically considered to be significant due to the CPA's familiarity with and potential bias towards their former work and employer.*
- *Apply Safeguards: Safeguards could include assigning the CPA to a different engagement where there is no self-review threat or ensuring that any work they did while employed by the client is independently reviewed by another team member.*
- *Continually Reassess: The CPA should be aware of the need to reassess their situation if their former employer becomes a client of the firm.*

#### **Example 4: Providing Non-Audit Services to an Audit Client**

*Scenario: A CPA's firm is asked to provide IT consulting services to an audit client.*

- *Identify Threats: Providing certain non-audit services can create a self-review threat or a management participation threat.*
- *Evaluate Threats: The significance will depend on the nature of the non-audit services and their relation to the audit subject matter.*
- *Apply Safeguards: Possible safeguards might include using professionals who are not part of the audit team to perform the services or ensuring the client makes all management decisions.*
- *Continually Reassess: The firm should monitor the scope of services provided to audit clients to ensure independence isn't compromised.*

## 2. Requirements of the Securities and Exchange Commission and the Public Company Accounting Oversight Board

*Remembering and Understanding: Understand the ethical and independence requirements of the Securities and Exchange Commission and the Public Company Accounting Oversight Board.*

### SEC Independence Requirements

The SEC's independence requirements are designed to ensure that auditors are able to objectively and impartially conduct audits of public companies.

- **Direct and Material Indirect Financial Interests:** Auditors must not have a direct financial interest or a material indirect financial interest in an audit client.
- **Employment Relationships:** Auditors cannot audit a company if certain members of management were recently employed by the auditing firm and worked on the company's audit.
- **Business Relationships:** Auditors must avoid any business relationship with the audit client that could compromise their independence.
- **Audit Partner Rotation:** Lead and reviewing audit partners are required to rotate off the audit every five years.
- **Non-Audit Services:** There are restrictions on the types of non-audit services that auditors can provide to their audit clients to prevent conflicts of interest.

*Example: An auditor is offered a position as the CFO of an audit client. To maintain independence, the auditor must refuse the job offer, and the firm must evaluate the need for safeguards or potentially resign from the audit engagement if the auditor had significant influence on the audit.*

## **PCAOB Independence Requirements**

The PCAOB establishes auditing and related professional practice standards for registered public accounting firms to follow in the preparation and issuance of audit reports.

- **Financial Relationships:** The PCAOB prohibits certain financial relationships with the audit client, similar to the SEC rules.
- **Non-Audit Services:** The PCAOB also has specific rules about the provision of non-audit services, similar to the SEC, which are designed to prevent auditors from acting as management or employees of the audit client.
- **Cooling-off Period:** A one-year cooling-off period is required before a member of the audit team can join an audit client in a key management position.
- **Tax Services:** The PCAOB places limitations on the tax services that auditors can provide to audit clients, especially those that may involve audit advocacy issues or are contingent on specific outcomes.

*Example: If a CPA firm provides tax services to an audit client where the service could be seen as contingent on the results of the audit, or the CPA firm's work will be subject to audit procedures during the audit, this could impair independence. In*

*this case, the firm should not provide such tax services to maintain compliance with PCAOB rules.*

## **Ethical Requirements**

Both the SEC and PCAOB emphasize the need for integrity and ethical behavior.

- Integrity and Objectivity: CPAs must maintain integrity and objectivity, free from conflicts of interest, and be independent in fact and appearance.
- Professional Skepticism: Auditors are required to exercise professional skepticism throughout the audit process.
- Confidentiality: Auditors must maintain the confidentiality of client information and not use it for personal gain.

*Example: An auditor discovers confidential information about an audit client's future product launch. The auditor must keep this information confidential and cannot purchase stock in the client company based on this information.*



*Application: Apply the ethical requirements and independence rules of the Securities and Exchange Commission and the Public Company Accounting Oversight Board to situations that could compromise compliance or impair independence during an audit of an issuer.*

Understanding and applying the ethical requirements and independence rules set by the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) is crucial for auditors of issuers.

### **1. Financial Relationships:**

Rule: Auditors must not have a financial stake in the companies they audit.

*Application Example: An audit partner owns shares in a client's company. The partner should divest these shares immediately upon learning of the assignment. The firm should also have a system in place to regularly check for any financial conflicts of interest among its employees.*

### **2. Employment Relationships:**

Rule: Auditors cannot audit a company if certain members of the client's management were recently employed by the auditing firm and had worked on the company's audit.

*Application Example: If a former employee of the audit firm is now the CEO of the audit client, the firm must evaluate the impact this has on their independence. Depending on the situation, it might require not accepting the audit engagement or putting additional safeguards in place, such as a review by an independent auditor.*



### **3. Non-Audit Services:**

Rule: There are restrictions on the types of non-audit services auditors can provide to their audit clients.

*Application Example: An audit client requests consulting services on implementing a financial information system. The audit firm must evaluate whether providing such services would compromise their independence by creating a self-review threat. If the service could be seen as significant or material to the financial statements, the firm should decline to provide it.*

### **4. Business Relationships:**

Rule: Auditors must avoid any business relationship with the audit client that is not in the ordinary course of business.

*Application Example: The audit firm is considering entering into a joint venture with an audit client. To maintain independence, the firm should not enter into this business relationship.*

### **5. Family and Personal Relationships:**

Rule: Close family members of the audit team should not be employed in a financial reporting oversight role at the audit client.

*Application Example: An auditor learns their spouse is being considered for the CFO position at the audit client. The auditor must report this to their firm so that actions can be taken to either remove the auditor from the engagement or, if the spouse accepts the position, to determine if the firm can continue the audit engagement.*

## **6. Provision of Tax Services:**

Rule: Auditors are restricted from providing certain tax services to their audit clients, particularly those that involve acting as management or advocacy for the client.

*Application Example: An audit client asks the firm for help in structuring a transaction in a tax-advantageous way. The auditor must assess whether this assistance could be perceived as taking on a management role or advocating for the client, potentially impairing independence.*

## **7. Audit Partner Rotation:**

Rule: The lead and concurring audit partners must rotate off the audit every five years.

*Application Example: An audit partner has served on a client's audit engagement for five years. The firm must ensure that the partner is replaced in accordance with the rotation requirements.*

## **8. Confidentiality:**

Rule: Auditors must maintain the confidentiality of client information.

*Application Example: An auditor overhears confidential information about an audit client's upcoming merger. They must keep this information confidential and not act upon it (e.g., trading stocks based on this information).*

### 3. Requirements of the Government Accountability Office and the Department of Labor

*Remembering and Understanding: Understand the ethical and independence requirements of the Government Accountability Office Government Auditing Standards.*

#### General Ethical Requirements

- **Public Interest:** Auditors should act in a manner that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
- **Integrity:** Auditors must perform their work with integrity, being honest and candid within the constraints of confidentiality. They must not subvert or misrepresent the facts.
- **Objectivity:** Auditors must be independent in mind and appearance and maintain an impartial, unbiased attitude on all matters related to the audit.
- **Proper Use of Government Information, Resources, and Positions:** Auditors must not misuse information or resources for personal gain or in a manner contrary to law or detrimental to the legitimate interests of the audit organization.
- **Professional Behavior:** Auditors must comply with laws and regulations and avoid any conduct that is discrediting to the profession.

## Independence Requirements

- **Non-audit Services Prohibition:** Auditors should not perform management functions or make management decisions for the audited entity.
- **Organizational Independence:** The audit organization should be free from external influences that can affect the ability to carry out the work objectively.
- **External Impairments to Independence:** Relationships or beliefs that could cause auditors to limit the extent of the work, overlook or tolerate improprieties, or slant audit findings are prohibited.
- **Internal Impairments to Independence:** Personal relationships or biased attitudes and beliefs within the audit organization that could affect impartiality must be avoided.
- **Audit Interference:** Auditors must not be deterred from engaging in lawful activities or from acting objectively and independently.
- **Management of Personal Impairments:** Auditors with personal relationships or external or organizational responsibilities that might impair their independence must report this to appropriate personnel within the audit organization.

**Independence in Appearance:** Auditors must avoid situations where a reasonable and informed third party would conclude that the auditors are not independent.

**Independence in Fact:** Auditors must be free from any interests or relationships that would cause them to take a position that is not objective.

## Application of Independence and Ethical Requirements

- Conflict of Interest: Auditors must continually monitor their work for personal or external pressures that might lead to a conflict of interest and address them as necessary.
- Self-Review Threat: Auditors must avoid auditing their own work or having any direct financial interest in the entities they audit.
- Professional Skepticism and Judgment: Auditors must maintain professional skepticism, questioning mind, and be alert to conditions that may indicate possible misstatements due to errors or fraud.

## Examples of Application

- *An auditor is asked to develop a new financial reporting system for a government entity that they will later audit. This would create a self-review threat to independence.*
- *An audit team member's spouse is employed by the audited entity in a key financial position. The team member should disclose this relationship, and the audit organization should assess whether this impairs independence.*
- *An auditor is considering running for public office, which might put pressure on them to conduct audits in a way that would be favorable to their political objectives. This potential impairment should be managed by either the auditor stepping down from the audit or the organization instituting safeguards.*

*Remembering and Understanding: Understand the independence requirements of the Department of Labor.*

The U.S. Department of Labor (DOL) oversees employee benefit plans, among other responsibilities, and has specific independence requirements for auditors of these plans under the Employee Retirement Income Security Act of 1974 (ERISA).

While the DOL does not have a detailed set of independence rules like the AICPA, SEC, or PCAOB, its requirements are intended to ensure that auditors are independent both in fact and in appearance when conducting audits of employee benefit plans.

It is important to emphasize that the DOL requires auditors to adhere to the AICPA Code of Professional Conduct and, where applicable, the independence standards of the SEC and PCAOB. However, because the DOL has enforcement authority over the audits of employee benefit plans, they can and do take action against auditors who fail to meet these independence requirements.

## **1. Direct Financial Interests**

Auditors cannot have a direct financial interest in the plan or plan sponsor. This would impair independence.

## **2. Material Indirect Financial Interests**

Material indirect financial relationships between the auditor and the plan or plan sponsor can impair independence. For example, if an audit firm has a significant amount of shares in a mutual fund that, in turn, has a significant stake in the plan sponsor, this could be viewed as a material indirect financial interest.

### **3. Family and Close Relationships**

Close relationships, such as those with family members who have a financial interest in the plan or plan sponsor, or who are in management positions with the plan, can impair independence.

### **4. Non-Audit Services**

Providing certain non-audit services to the plan or plan sponsor may impair independence. The auditor must be cautious about the scope and nature of any additional services provided, ensuring they do not cross into management decision-making or confidential information.

### **5. Long-standing Audit Relationships**

While not a formal rule like the PCAOB's partner rotation requirements, long-term audit relationships can be scrutinized by the DOL for potential impairment of independence.

### **6. Contingent Fees**

Auditors cannot accept fees that are contingent on the outcome of their audit work. Fees must be predetermined and not influenced by the results of the audit.

### **7. Required Communications**

Auditors must communicate with those charged with governance regarding any relationships or services that may reasonably be thought to bear on independence, and document the substance of that communication.

## **Application and Scenarios:**

*Scenario: An auditor's spouse is employed by a company that sponsors an employee benefit plan the auditor is auditing.*

*Action: The auditor should disclose the relationship to the appropriate parties and determine if safeguards or the removal of the auditor from the engagement are necessary.*

*Scenario: An audit firm is asked to implement a financial information system for the plan and then audit its effectiveness.*

*Action: The audit firm should decline the implementation service or ensure that the audit team is completely separate and independent from the team that provides the non-audit service.*

*Scenario: An audit partner has been leading the audit of an employee benefit plan for several years and has developed close personal relationships with the management of the plan sponsor.*

*Action: The audit firm may consider rotating the audit partner off the engagement to mitigate any appearance of a lack of independence.*



*Application: Apply the ethical requirements and independence rules of the Government Accountability Office Government Auditing Standards to situations that could present threats to compliance during an audit of, or attestation engagement for, a government entity or an entity receiving federal awards.*

## **Understanding the Yellow Book's Ethical Requirements and Independence Rules**

Before applying these standards, one must understand the foundational principles that the Yellow Book establishes:

- Public interest: Auditors should act in a manner that will serve the public trust.
- Integrity: Auditors must perform their work with honesty and diligence.
- Objectivity: Auditors should be impartial, intellectually honest, and free of conflicts of interest.
- Proper use of government information, resources, and positions: Auditors must be prudent in the use of information and resources.
- Professional behavior: Auditors must comply with laws and regulations and avoid any conduct that discredits the profession.

## **Applying the Standards in Practice**

The application of these principles in various situations can be explored through a four-step process:

## **Step 1: Identify Potential Threats**

First, identify threats that could impair independence or breach ethical requirements such as:

- Self-interest threats (financial or other interests).
- Self-review threats (auditing one's own work).
- Advocacy threats (promoting a client's interests).
- Familiarity threats (close relationships with auditees).
- Undue influence threats (external pressures on the auditor).

## **Step 2: Evaluate the Significance of Threats**

Once identified, evaluate the significance of these threats in context. Consider the likelihood and potential impact of the threat materializing. If a threat is deemed significant, it must be addressed.

## **Step 3: Apply Safeguards**

If threats are significant, apply safeguards to eliminate them or reduce them to an acceptable level. This could include:

- Changing the audit team.
- Implementing additional supervisory measures.
- Seeking external advice or peer reviews.
- Disclosing the threat to appropriate parties.
- Refraining from the service that creates the threat.

## Step 4: Document the Process

Document each step of this process:

- The identified threats and their evaluated significance.
- The safeguards applied and their rationale.
- The conclusion on whether sufficient safeguards are in place to eliminate or reduce threats to an acceptable level.

## Examples and Application

### Example: Financial Interest in Audited Entity

- *Identification: An auditor has a small investment in a government entity they are assigned to audit.*
- *Evaluation: The investment could constitute a self-interest threat to independence.*
- *Safeguards: Divestment of the financial interest or reassignment of the auditor to another engagement.*
- *Documentation: Record the investment, the evaluation of the threat, and the action taken to mitigate it.*

### Example: Prior Employment with Audited Entity

- *Identification: An auditor was previously employed by the entity they are now auditing.*
- *Evaluation: The previous employment could create a self-review or familiarity threat.*
- *Safeguards: A cooling-off period or assigning the auditor to a different team or engagement.*
- *Documentation: Note the prior employment, its significance, and the mitigation measures adopted.*

## Example: Offering Non-Audit Services

- *Identification: The audit firm is asked to provide consulting services on internal control design for an entity they audit.*
- *Evaluation: Providing these services could lead to a self-review threat.*
- *Safeguards: Ensuring that different personnel provide the non-audit services or rejecting the non-audit engagement.*
- *Documentation: Detail the services requested, the potential threat, and the decision made regarding service provision.*

*Application: Apply the independence rules of the Department of Labor to situations when an accountant would not be considered independent during an audit of employee benefit plans.*

## **Applying DOL Independence Rules**

Here's how an auditor can apply DOL rules to common scenarios to determine if they are independent:

### **Scenario 1: Ownership Interest**

Situation: An auditor owns stock in the company that sponsors the employee benefit plan.

DOL Rule Application: Direct ownership is a clear violation of independence standards. The auditor must dispose of the stock or be removed from the audit.

### **Scenario 2: Family Member Employment**

Situation: A close family member of the auditor works in a financial position at the plan sponsor.

DOL Rule Application: Employment of a close family member in a key financial position at the plan sponsor is a breach of independence. The auditor would need to assess the materiality of the relationship and, if significant, should not participate in the audit.

### **Scenario 3: Non-Audit Services**

Situation: The audit firm provides additional non-audit services to the plan sponsor.

DOL Rule Application: Providing certain non-audit services, especially those related to financial information systems design and implementation, can impair independence. The auditor must ensure these services do not relate directly to the audit subject matter and that management of the plan sponsor remains responsible for all decision-making.

#### **Scenario 4: Recent Employment with Plan Sponsor**

Situation: An auditor was recently employed by the plan sponsor and is now on the audit team for the plan.

DOL Rule Application: The auditor has a self-review threat due to recent employment. A cooling-off period is required where the auditor should not participate in the audit until sufficient time has elapsed to mitigate the threat.

### **Documentation**

In each scenario, auditors must:

- Identify potential relationships or services that may pose a threat to independence.
- Evaluate the significance of the threat to determine if it is at a level that would be considered material or if it could influence the audit outcome.
- Document the situation, evaluation, and any mitigating actions taken to preserve independence in the audit workpapers.

## B. Professional Skepticism and Professional Judgment

*Remembering and Understanding: Understand the concepts of professional skepticism and professional judgment.*

**Professional Skepticism** is an attitude that includes a questioning mind and a critical assessment of audit evidence. It requires auditors not to accept evidence at face value and to be alert to evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance.

### Key Aspects

- **Questioning Mind:** Approach audits with a mindset that assumes no information is free from potential error or fraud.
- **Critical Assessment:** Evaluate the validity of audit evidence and its relevance and reliability.
- **Alertness to Conditions:** Remain alert to conditions that may indicate possible misstatement due to error or fraud.

### Application in Audits

- **Evidence Evaluation:** Scrutinize the quality and sufficiency of audit evidence.
- **Assessment of Management Assertions:** Challenge the assumptions and assertions made by management.

- Identification of Fraud Indicators: Stay vigilant for any signs or risks of material misstatement due to fraud.

**Professional Judgment** is the application of relevant training, knowledge, and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the appropriate courses of action during the audit engagement.

### **Key Aspects**

- Knowledge and Experience: Leverage personal experience and knowledge in auditing standards.
- Ethical Understanding: Apply an ethical framework to decisions.
- Reasonable Decisions: Make decisions that are consistent with the totality of the evidence and auditing standards.

### **Application in Audits**

- Risk Assessment: Use judgment to identify and assess risks of material misstatement.
- Materiality Determination: Decide on materiality levels for audit purposes.
- Audit Conclusion: Arrive at a conclusion based on the evidence gathered during the audit.



*Remembering and Understanding: Understand unconscious auditor biases and other impediments to acting with professional skepticism, including threats, incentives and judgment-making shortcuts.*

Professional skepticism is a foundational principle in auditing, essential for the critical assessment of evidence and for making informed judgments. Despite its importance, auditors can face several unconscious biases and other impediments that can hinder their ability to act with professional skepticism.

## **Unconscious Auditor Biases**

**1. Confirmation Bias:** This occurs when auditors focus on information that confirms their existing beliefs or hypotheses and disregard information that contradicts them. For example, if an auditor expects a certain financial statement to be accurate based on past experiences, they may unintentionally overlook evidence to the contrary.

**2. Anchoring Bias:** Auditors may give disproportionate weight to the first information they receive, known as the "anchor," and then interpret subsequent information around this anchor. This can skew the audit findings if the initial information is not representative or accurate.

**3. Overconfidence Bias:** Auditors may overestimate their own abilities or the accuracy of their judgments, leading to less rigorous investigations and a reduced tendency to seek additional evidence.

**4. Availability Bias:** This bias occurs when auditors judge the probability of events based on how easily instances

come to mind. For example, if an auditor has recently dealt with a fraud case, they may overestimate the likelihood of fraud in their current audit.

**5. Familiarity Bias:** When auditors have longstanding relationships with clients, they may become too trusting or accepting of the client's practices and representations, leading to a lack of skepticism.

### **Other Impediments to Professional Skepticism**

**1. Time Pressure:** Tight deadlines may lead auditors to take shortcuts or not devote sufficient time to critical analysis and evidence gathering.

**2. Resource Limitations:** Lack of access to necessary tools or adequate personnel can impede thorough investigation and evidence collection.

**3. Cognitive Overload:** Auditors may be overwhelmed with information, making it difficult to process all relevant data effectively.

### **Threats, Incentives, and Judgment-Making Shortcuts**

**1. Self-Interest Threat:** This occurs when an auditor's personal interests, such as the desire for continued business from the client, conflict with the duty to act objectively.

**2. Familiarity Threat:** Close relationships with a client or its personnel can lead to sympathy with their interests, reducing skepticism.

**3. Intimidation Threat:** Auditors might face pressure from clients to agree with their accounting practices or conclusions, threatening the auditor's ability to remain objective.

**4. Advocacy Threat:** When auditors promote a client's interests or position, their ability to remain neutral and skeptical is compromised.

**5. Incentive Systems:** Bonuses or other incentives tied to client retention or satisfaction can impair an auditor's impartiality.

**6. Judgment-Making Shortcuts (Heuristics):** Auditors might rely on rules of thumb or heuristics to make quick judgments, which can lead to systematic errors or biases.

## Mitigating Factors

**1. Training and Awareness:** Regular training on biases and professional skepticism can make auditors more aware of their own thought processes and potential pitfalls.

**2. Diverse Teams:** Having a diverse team with different perspectives can reduce the likelihood of groupthink and increase the chance of identifying biases.

**3. Quality Controls:** Implementing strong quality control processes within audit firms can help ensure that audits are conducted with due professional care.

**4. Mindfulness Practices:** Encouraging mindfulness and reflective thinking can help auditors recognize when they are falling into biased patterns of thought.

**5. External Review and Oversight:** Periodic reviews by external parties can provide a check on the audit process and help ensure that professional skepticism is maintained.

SAMPLE

## C. Nature and Scope

### 1. Audit Engagements

*Remembering and Understanding: Identify the nature, scope and objectives of the different types of audit engagements for issuers and nonissuers.*

#### **Audit Engagements for Issuers**

**Issuers** are entities that have securities traded on a public market. Audits of issuers are conducted under the standards of the Public Company Accounting Oversight Board (PCAOB).

#### **Nature of Engagements**

- Integrated Audit: Includes a financial statement audit along with an audit of internal control over financial reporting (ICFR), as required by the Sarbanes-Oxley Act (SOX).
- Compliance Audit: Ensures compliance with the regulations set forth by the SEC and other regulatory bodies.

#### **Scope**

- Financial Statement Audit: Involves testing the financial statements for material misstatements and providing an opinion on their fairness.
- ICFR Audit: Assesses the effectiveness of the entity's internal controls over financial reporting.

#### **Objectives**

- Opinion on Financial Statements: To express an opinion on whether the financial statements are presented

fairly, in all material respects, in conformity with the applicable financial reporting framework.

- Opinion on ICFR: To express an opinion on the effectiveness of the entity's ICFR.

## **Audit Engagements for Nonissuers**

**Nonissuers** are entities that do not have securities traded on a public market. Audits of nonissuers are generally conducted under Generally Accepted Auditing Standards (GAAS) issued by the AICPA.

### **Nature of Engagements**

- Financial Statement Audit: Examination of financial statements to provide an opinion on their accuracy and compliance with the applicable framework.
- Review Engagement: Provides limited assurance on financial statements and involves less extensive procedures than an audit.
- Compilation Engagement: Assists management in presenting financial information without providing any assurance.

### **Scope**

- Financial Statement Audit: Involves obtaining reasonable assurance about whether the financial statements are free of material misstatement.
- Review Engagement: Involves performing inquiry and analytical procedures to provide a basis for limited assurance.

- **Compilation Engagement:** Consists of presenting information in the form of financial statements without undertaking to obtain or provide any assurance.

### **Objectives**

- **Opinion on Financial Statements (Audit):** To express an opinion on the fairness of the presentation of financial statements in accordance with the applicable financial reporting framework.
- **Conclusion (Review):** To provide a conclusion whether, based on the review, anything has come to the auditor's attention that causes the auditor to believe the financial statements are not presented fairly.
- **No Assurance (Compilation):** To assist management in presenting financial information but not to provide any assurance on the financial statements.



## 2. Engagements Conducted Under Government Accountability Office Government Auditing Standards

*Remembering and Understanding: Identify the nature, scope and objectives of engagements performed in accordance with Government Accountability Office Government Auditing Standards, including single audits.*

### The Yellow Book Standards

The "Yellow Book" is the colloquial name for the GAO's Government Auditing Standards. It provides a framework for conducting high-quality audits with competence, integrity, objectivity, and independence.

### Nature of Engagements

- **Financial Audits:** Provide an opinion on whether financial statements are presented fairly in all material respects in accordance with the applicable financial reporting framework.
- **Performance Audits:** Evaluate the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.
- **Attestation Engagements:** Examine, review, or perform agreed-upon procedures on a subject matter, or an assertion about a subject matter, and report on the results.

## Single Audits

A single audit is a rigorous, organization-wide audit or examination of an entity that expends \$750,000 or more of federal assistance (federal funds, grants, and awards) received for its operations. Usually, single audits are required for states, local governments, and non-profit organizations.

## Scope of Engagements

- **Financial Audits:** Include assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.
- **Performance Audits:** Cover a variety of objectives, including assessments of program effectiveness, compliance with laws and regulations, and financial or economic impacts.
- **Attestation Engagements and Single Audits:** Involve obtaining evidence about the use of governmental or other funds to assess compliance with related laws and regulations.

## Objectives

- **Financial Audits:** To express opinions on the fairness of financial statements, and, where applicable, the effectiveness of internal controls over financial reporting.
- **Performance Audits:** To provide objective analysis to improve program performance and operations, reduce costs, facilitate decision-making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.

### 3. Other Engagements

*Remembering and Understanding: Identify the nature, scope and objectives of attestation engagements and accounting and review service engagements.*

#### Attestation Engagements

**Nature:** Attestation engagements involve the CPA being engaged to issue a report on subject matter, or an assertion about subject matter, that is the responsibility of another party. These engagements are broader than financial statement audits and can encompass a variety of financial and non-financial information.

**Scope:** The scope of an attestation engagement may vary greatly and could include:

- Examination of financial forecasts
- Review of compliance with contractual agreements
- Reporting on internal control over financial reporting
- Providing assurance on sustainability reports

**Objectives:** To provide a conclusion about the reliability of the subject matter or assertion in question.

To enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of the subject matter against criteria.

## Accounting and Review Service Engagements

**Nature:** These engagements involve preparation, compilation, and review services for financial statements. They do not provide the same level of assurance as audits but are important for entities that do not require an audit.

### Scope

- **Preparation Engagements:** Preparing financial statements without providing any assurance to the user of the financial statements.
- **Compilation Engagements:** Assisting management in presenting financial information in the form of financial statements without providing assurance on that information.
- **Review Engagements:** Performing inquiry and analytical procedures to provide a reasonable basis for obtaining limited assurance that no material modifications should be made to the financial statements.

### Objectives

- **Preparation Engagements:** To assist management in presenting financial information in the form of financial statements.
- **Compilation Engagements:** To assist the entity with financial information representation and disclose the CPA's lack of independence, if applicable.
- **Review Engagements:** To provide users with comfort that, based on the CPA's review, the financial statements do not require any material modifications to be in conformity with the applicable financial reporting framework.

## **D. Terms of Engagement**

### **1. Preconditions for an Engagement**

*Remembering and Understanding: Identify the preconditions needed for accepting or continuing an engagement.*

#### **Understanding the Entity and Its Environment**

- The auditor should obtain an understanding of the entity and its environment, including its internal control.
- This understanding is crucial for planning the audit and determining the nature, timing, and extent of audit procedures.

#### **Compliance with Ethical Requirements**

- The auditor must comply with relevant ethical requirements, including independence.
- An evaluation of compliance with ethical requirements, including the AICPA Code of Professional Conduct, should be performed before accepting the engagement.

#### **Acceptance and Continuance of Client Relationships and Audit Engagements**

Determine whether the acceptance or continuance of a client relationship and the audit engagement is in the best interests of the firm.

## **Audit Agreement**

- The auditor should ensure that there is an agreement on the audit's terms with management or those charged with governance.
- This typically includes a written engagement letter outlining the scope and objectives of the audit, the auditor's and management's responsibilities, and any limitations of the engagement.

## **Management's Responsibilities**

- The auditor must confirm that management understands its responsibilities:
  - For the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
  - For internal control relevant to the preparation and fair presentation of the financial statements.
  - To provide the auditor with access to all information relevant to the preparation of the financial statements and any additional information that the auditor may request from management.

## **Preconditions for an Audit**

- The auditor should assess whether the following preconditions are present:
  - The financial reporting framework to be applied in the preparation of the financial statements is acceptable.
  - Management and, where appropriate, those charged with governance, acknowledge and understand their

responsibilities for the preparation of the financial statements in accordance with the applicable financial reporting framework, for internal control, and to provide the auditor with all relevant information and access as mentioned above.



## 2. Terms of Engagement and the Engagement Letter

*Remembering and Understanding: Identify the factors affecting the acceptance or continuance of an engagement, including communication with predecessor auditors.*

### Terms of Engagement

#### Understanding the Terms of Engagement:

- The terms of engagement define the scope of the audit work, the responsibilities of the auditor, the management responsibilities, and any limitations of the engagement.
- These terms are typically documented in an engagement letter and should be agreed upon by both the auditor and the client before the audit commences.

#### Elements of the Engagement Letter:

- Objective and scope of the audit
- Auditor's responsibilities
- Management's responsibilities
- Identification of the applicable financial reporting framework
- Reference to the expected form and content of any reports to be issued by the auditor

## **Factors Affecting Acceptance or Continuance of an Engagement**

### **Integrity of Management**

- Assess the integrity of management and those charged with governance.
- Consider the reputation of the client and any risks associated with being connected to the client.

### **Independence and Ethical Compliance**

- Determine whether the firm can maintain independence, both in fact and appearance.
- Evaluate any threats to compliance with ethical requirements and whether appropriate safeguards are in place.

### **Competence and Capability**

- Ensure that the engagement team has the necessary competence and capability to perform the audit.
- Consider the firm's resources and whether they are sufficient to meet the engagement's demands.

### **Legal and Regulatory Requirements**

- Confirm that the engagement can be conducted in accordance with legal and regulatory requirements.
- Understand the client's operations and industry regulations that may affect the audit.

## **Financial Viability of the Client**

Consider the financial viability of the client and whether there is a risk the client may not be able to continue operations.

## **Communication with Predecessor Auditors**

### **Why Communicate with Predecessor Auditors?**

To inquire about any reasons that might influence the decision to accept or continue the engagement, such as disagreements with management over accounting policies or auditing procedures.

### **Required Communications**

- Make an inquiry of the predecessor auditor regarding the integrity of management, disputes over accounting principles, and the reasons for the change of auditors.
- Obtain permission from the client to discuss the client's affairs with the predecessor auditor.

### **Legal and Ethical Considerations**

- Ensure that any communication with predecessor auditors complies with confidentiality and privacy laws and regulations.
- Be aware of and comply with any ethical guidelines concerning such communication.

*Remembering and Understanding: Recall when it is acceptable to agree to management's request for a change in the type of engagement (e.g., from an audit to a review).*

## **Evaluating Management's Request**

### **Legitimate Reasons for Changing Engagement Type:**

- A change in user requirements: If the financial information users' needs change, they may no longer require an audit and may be satisfied with a review or compilation.
- A change in ownership or management: New management or owners may have different requirements.
- A change in the financial status of the company: A downturn in business may lead to a cost-benefit reconsideration of the audit versus review.

### **Questionable Reasons for Changing Engagement Type:**

- Management's desire to avoid disclosure of fraud or illegal acts discovered during an audit.
- Disagreements on accounting principles or audit procedures.
- Restrictive scope during an audit engagement that won't allow the auditor to complete the audit.

## Required Steps Before Agreeing to Change the Engagement

**Communication:** Communicate with management to understand the reasons for the change and to determine whether there is any pressure on the auditor to reduce the scope of the work.

**Documentation:** Document the reasons for the change provided by management.

If an audit has already begun, include the work performed up to the change and any significant findings.

**Independence and Objectivity:** Consider any independence or objectivity issues that may arise due to a change in the engagement.

**Review Legal and Contractual Obligations:** Review any contractual obligations or regulatory requirements that may necessitate a certain level of engagement.

**Evaluate the Appropriateness:** Consider whether a lower level of assurance would be appropriate given the circumstances and whether the change could be seen as misleading to the users of the financial statements.

**Issue Communication to Management:** If the change is deemed appropriate, communicate the new terms of engagement and have management acknowledge the change in writing.

**Professional Judgment:** Use professional judgment to evaluate the implications of the change and whether it complies with ethical guidelines and standards.

### **Accepting the Change in Engagement Type**

- Ensure that the reasons for the request are legitimate and do not compromise the integrity of the financial reporting process.
- Obtain a written representation from management regarding the reasons for the change.
- Issue a new engagement letter reflecting the change in terms and obtain signatures from the client.

*Application: Perform procedures to confirm that a common understanding of the terms of an engagement exist with management and those charged with governance.*

## **Key Steps for Confirming Engagement Terms**

### **1. Initial Evaluation:**

- **Assess the Client:** Understand the client's operations, governance structure, and the requirements of the engagement.
- **Identify the Appropriate Contacts:** Determine who in management and the governance structure should be involved in discussions about the engagement terms.

### **2. Drafting the Engagement Letter:**

- **Outline the Scope:** Clearly define what the engagement will cover, including the objectives, responsibilities, and limitations.
- **Detail the Responsibilities:** Specify the responsibilities of both the auditor and the client, including the preparation of financial statements.
- **Specify the Reports:** Describe the expected types and formats of reports or communications to be issued by the auditor.

### **3. Discussions with Management and Governance:**

- **Meeting to Discuss Terms:** Arrange a meeting with the key individuals in management and those charged with governance to discuss the terms of the engagement.

- **Clarify Expectations:** Use this opportunity to ensure that all parties have the same expectations regarding the audit's scope and outcome.
- **Address Questions:** Be ready to answer any queries regarding the audit process, the auditor's responsibilities, or any terms within the engagement letter.

#### **4. Documentation:**

- **Engagement Letter:** Prepare a written engagement letter based on the discussions and send it to management and those charged with governance.
- **Acknowledgment and Acceptance:** Obtain written acknowledgment and acceptance of the terms from both parties prior to commencing the engagement.

#### **5. Continuous Communication:**

- **Maintain Open Lines of Communication:** Ensure there are clear channels for ongoing dialogue throughout the engagement.
- **Document Changes:** If terms change during the engagement, document these changes and obtain new acknowledgments from all parties involved.

#### **6. Review by Engagement Team:**

**Team Briefing:** Ensure that the entire engagement team understands the terms and any nuances that might impact the audit procedures or focus areas.



## **7. Final Confirmation:**

Written Representation: Before the conclusion of the engagement, obtain a final written representation from management and those charged with governance confirming they understand and agree to the terms.

*Application: Document the terms of an engagement in a written engagement letter or other suitable form of written agreement.*

## **An Example Engagement Letter**

*[Your Firm's Letterhead]*

*[Date]*

*[Client's Name]*

*[Client's Address]*

*Subject: Engagement Letter for Audit Services*

*Dear [Client's Contact Name],*

*We appreciate the opportunity to provide audit services for [Client's Company Name] for the fiscal year ending [Fiscal Year End Date]. This letter confirms the terms and objectives of our engagement and the nature and limitations of the services we will provide.*

### **Scope of Services:**

*We will conduct our audit in accordance with Generally Accepted Auditing Standards (GAAS) and the standards established by the Public Company Accounting Oversight Board (PCAOB), where applicable. Our audit will be designed to obtain reasonable assurance about whether the financial statements as a whole are free of material misstatement, whether due to fraud or error.*

**Responsibilities of Management:**

*Management is responsible for the preparation and fair presentation of financial statements in accordance with [Specify the Financial Reporting Framework]. This includes designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement.*

**Auditor's Responsibilities:**

*Our responsibility is to express an opinion on the financial statements based on our audit. We will conduct our audit in a manner that allows us to provide reasonable assurance that the financial statements are free of material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.*

**Access to Information:**

*You agree to provide us with access to all information of which you are aware that is relevant to the preparation and fair presentation of the financial statements, including all records, documentation, and other matters. Additionally, you agree to provide unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.*

**Fees and Billing:**

*Our fees are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. We will bill you [monthly/upon milestone completion/at the end of the audit] and payment is due upon receipt of the invoice.*

**Other Services:**

*If any additional services are requested that are outside the scope of this letter, we will communicate the terms and any additional fees in a separate engagement letter.*

*Please sign and return the enclosed copy of this letter to acknowledge your acceptance of the terms of our audit engagement. If you have any questions, please contact us at [Your Contact Information].*

*Thank you for choosing [Your Firm's Name] to assist you with your auditing needs.*

*Sincerely,*

*[Your Name]*

*[Your Position]*

*[Your Firm's Name]*

*Acknowledged and Agreed:*

*By: \_\_\_\_\_*

*Title: \_\_\_\_\_*

*Date: \_\_\_\_\_*

## E. Requirements for Engagement Documentation

*Remembering and Understanding: Identify the elements that comprise sufficient appropriate documentation in physical or electronic form for an engagement.*

### Purpose of Documentation

Engagement documentation, often referred to as the audit working papers or audit file, provides:

- Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor.
- Evidence that the audit was planned and performed in accordance with Generally Accepted Auditing Standards (GAAS) and applicable legal and regulatory requirements.

### Elements of Sufficient Appropriate Documentation

#### 1. Nature, Timing, and Extent of Audit Procedures Performed:

- Audit Plan and Approach: Documentation should include the nature, timing, and extent of planned audit procedures, as well as any changes to those plans and the reasons for those changes.
- Procedures and Tests: Detailed records of the audit procedures performed, the audit evidence obtained, and the conclusions drawn from that evidence.
- Compliance Checks: Documentation that compliance with auditing standards has been achieved.

## **2. Identification of Engagement Team:**

A record of who performed the work and the date the work was completed, as well as who reviewed the audit work and the date of such review.

## **3. Audit Evidence and Conclusions:**

- **Audit Evidence:** Detailed information that supports the auditor's conclusions and includes the source, nature, and extent of the audit evidence obtained.
- **Analytical Procedures:** Results of any analytical procedures performed, including the rationale and results of substantive analytical procedures.
- **Risks and Responses:** Documentation of identified risks and how the audit was tailored to respond to those risks.

## **4. Accounting Records and Financial Statements:**

A record of the audit's reconciliation with the financial statements and notes on any significant matters that were discussed with management, those charged with governance, or others, including the basis for significant judgments and conclusions.

## **5. Significant Matters:**

Documentation related to significant findings or issues, including the rationale for significant judgments made in reaching conclusions on significant matters, such as the basis for the resolution of accounting and auditing issues.

## **6. Independence Documentation:**

Confirmation of the auditor's independence with respect to the audit engagement.

## **7. Engagement Completion:**

An assembly of the final engagement file that contains the final documents that support the auditor's report, and evidence that the auditor has obtained the necessary approvals for the release of the report.

## **8. Retention Period:**

Documentation should be retained for a period sufficient to meet the needs of the engagement and to satisfy any applicable legal or regulatory requirements for record retention.

## **Format and Organization**

- **Clear Organization:** Documentation should be organized to provide a clear link to the significant findings or issues.
- **Indexing and Cross-referencing:** Proper indexing and cross-referencing for all working papers.
- **Confidentiality and Security:** Maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of documentation.

*Remembering and Understanding: Identify the requirements for the assembly and retention of documentation in physical or electronic form for an engagement.*

## **Assembly of Engagement Documentation**

- **Final Assembly Deadline:** Audit documentation should be assembled within a certain period following the report release date, typically 60 days.
- **Completeness of Documentation:** The documentation should be complete in all material respects. It should include all significant findings or issues, the auditor's conclusions, and significant professional judgments made in reaching those conclusions.
- **Organizational Structure:** Documents should be organized systematically to enable a clear understanding of the work performed, evidence obtained, and conclusions reached.

## **Retention of Engagement Documentation**

- **Retention Period:** Auditors are required to retain engagement documentation for a minimum number of years from the date of the auditor's report, or the date of the group auditor's report if applicable. The specific period can vary based on jurisdiction, but a common period is five years.
- **Legal and Regulatory Requirements:** Auditors must comply with any applicable legal or regulatory requirements that may extend the retention period.
- **Access:** Only authorized personnel should have access to these documents, and the audit firm should have policies and procedures to prevent unauthorized changes to the documentation.



## **Electronic Documentation Considerations**

- Security: Use secure systems to prevent unauthorized access, modifications, or deletions to the documentation.
- Backups: Regularly back up electronic documentation to protect against data loss.
- Integrity: Maintain the integrity of electronic documentation through version control and audit trails.

## **Documentation after the Assembly Period**

- Post Assembly Modifications: After the assembly period, modifications to the audit documentation should only be made if they are to correct inaccuracies or facilitate understanding.
- Record of Changes: A record should be maintained of who made the post-assembly changes, when, and why.

## **Final Checklist for Engagement Documentation**

- Have all relevant documents been included and tagged?
- Is there a clear index or reference system for the documentation?
- Are confidentiality and data protection protocols in place and adhered to?
- Has the documentation been reviewed and approved by the appropriate level of the audit team?
- Is there a mechanism to ensure compliance with both the firm's and professional standards for documentation retention?

*Application: Prepare documentation that is sufficient to enable an experienced auditor or practitioner having no previous connection with an engagement to understand the nature, timing, extent and results of procedures performed, the significant findings and conclusions reached and the significant professional judgments made.*

### **Example of Engagement Documentation**

***Audit Engagement: XYZ Corporation - Year Ended December 31, 20XX***

***Workpaper Reference: W-300***

***Nature of Procedure: Test of controls over cash disbursements***

***Timing: Completed on March 10, 20XX***

***Extent of Procedure:***

- *Sample size: 40 selections*
- *Period under review: January 1, 20XX to December 31, 20XX*
- *Method of selection: Random sampling from the population of cash disbursement entries*

***Procedure Performed:***

- *Evaluated the design of controls related to cash disbursements.*
- *Tested the operating effectiveness of controls by verifying approvals, comparing recorded transactions to supporting documentation, and re-performing reconciliations.*

- *Investigated any items that appeared unusual or that lacked proper authorization.*

### **Results of Procedure:**

- *Of the 40 transactions tested, 38 were found to have proper authorization and documentation.*
- *2 transactions did not have a signed approval form; however, upon further inquiry, verbal approval was confirmed with the responsible manager.*

### **Significant Findings and Conclusions:**

- *Controls over cash disbursements are operating effectively, with the exception of occasional lapses in the documentation of approval.*
- *The exceptions noted did not result in material misstatements and were attributed to oversight by the approving manager.*

### **Significant Professional Judgments Made:**

- *The risk of material misstatement due to fraud in cash disbursements was assessed as low, based on the company's segregation of duties and past history of accurate reporting.*
- *The absence of a signature was not considered indicative of a control deficiency due to corroborative evidence of verbal approval and consistent past behavior from the manager.*

### **Documentation Includes:**

- *Summary of the control environment related to cash disbursements.*

- *Details of the sample selected, including rationale for the sample size and selection method.*
- *Evidence of testing performed, including copies of sampled documents with auditor annotations.*
- *Analysis of deviations and results of additional inquiry.*
- *Conclusions regarding the effectiveness of controls tested.*
- *Record of discussions with management regarding the findings and their response.*

*Preparer: [Auditor's Name]*

*Reviewer: [Reviewer's Name]*

*Date of Review: [Date]*

***Reviewer's Comments:***

- *Reviewed the work performed and agree with the conclusions reached by the auditor.*
- *Recommend discussion with management regarding the importance of fully documented approvals.*

## **F. Communication With Management and Those Charged With Governance**

### **1. Planned Scope and Timing of an Engagement**

*Remembering and Understanding: Identify the matters related to the planned scope and timing of an engagement that should be communicated to management and those charged with governance.*

#### **Objectives of Communication**

- To ensure that management and those charged with governance are informed about the auditor's approach to the engagement.
- To discuss significant findings, including any significant risks identified during the planning stage.
- To provide an opportunity for those charged with governance to discuss the planned audit and to provide insights that may be relevant to the audit.

#### **Matters to Communicate**

##### **1. Overview of the Planned Scope:**

- Nature of the Audit: Explain the nature of an audit, focusing on the fact that it is designed to provide reasonable assurance about whether the financial statements are free from material misstatement.
- Audit Areas: Outline the areas of the financial statements that will receive primary focus, especially areas involving significant risks or complex transactions.

- **Materiality:** Discuss the concept of materiality and how it will influence the scope and focus of the audit procedures.

## **2. Timing of the Audit:**

- **Audit Schedule:** Provide a timeline of the audit process, highlighting the expected start date, key milestones, and the anticipated completion date.
- **Reporting Deadlines:** Outline any known reporting deadlines, such as regulatory filings or board meetings, that may affect the timing of the audit.
- **Availability of Information:** Stress the importance of timely access to information and the cooperation of management in providing necessary documentation and explanations.

*Application: Prepare presentation materials and supporting schedules for use in communicating the planned scope and timing of an engagement to management and those charged with governance.*

## **Preparing Presentation Materials and Supporting Schedules**

### **Understanding Your Audience**

- Identify the Knowledge Level: Gauge the financial and auditing knowledge of the audience to tailor the complexity of the presentation.
- Consider Their Interests: Focus on areas of the audit that are especially relevant to the audience (e.g., areas with significant changes from prior periods).

### **Structuring the Presentation**

- Introduction: Briefly outline the objectives and importance of the audit.
- Executive Summary: Summarize the key points of the planned scope and timing before diving into the details.
- Detailed Scope: Explain the areas that the audit will cover, specifying any changes or areas of increased focus since the last audit.
- Timing: Outline the audit timeline, highlighting critical milestones, including the interim and final audit phases.

### **Creating Supporting Schedules**

- Audit Plan Schedule: Include a detailed timeline, milestones, and key deliverables.
- Materiality and Sampling: Document the basis for determining materiality and the approach to sampling.

- Risk Assessment Documentation: Provide a schedule that illustrates how risks were assessed and the corresponding audit responses.

## **Visual Aids**

- Flowcharts: Illustrate the audit process from planning to reporting.
- Gantt Charts: Show the timing and duration of audit activities.
- Risk Heat Maps: Visually present the identified risks and their significance.

## **Designing the Presentation**

- Clarity: Use clear and concise language, avoiding jargon when possible.
- Consistency: Maintain consistent formatting and design for professional appearance.
- Visual Engagement: Utilize graphs, charts, and tables to make data more accessible.

## **Preparing for the Presentation**

- Rehearse: Practice delivering the presentation to build confidence and ensure it flows logically.
- Anticipate Questions: Be ready to answer questions on the scope, timing, and audit approach.
- Feedback: If possible, do a trial run with a colleague to get feedback.

## **Presentation Tips**

- Start Strong: Open with a clear statement of the audit's value and objectives.
- Engage the Audience: Encourage questions and interaction to ensure understanding.



- Focus on Key Points: Emphasize areas of significant changes or particular interest to management and governance.

### **Supporting Schedule Details**

- Audit Scope: Break down the audit areas and the rationale for their inclusion.
- Timing: Provide specific dates and dependencies.
- Risk Assessment: List risks by area, with the corresponding audit procedures.

### **Finalizing Materials**

- Review and Edit: Go over the materials to correct any errors and ensure all information is up to date.
- Backup Documentation: Have detailed documentation ready for those who may request deeper insights.

### **Follow-up**

- Documentation: Ensure all presentation materials are documented in the work papers.
- Action Items: Close with any required actions from management or those charged with governance.

## 2. Internal Control Related Matters

*Remembering and Understanding: Identify the matters related to deficiencies and material weaknesses in internal control that should be communicated to those charged with governance and management for an engagement and the timing of such communications.*

### **Communicating Internal Control Deficiencies and Material Weaknesses**

#### **Understanding Deficiencies and Material Weaknesses**

- **Deficiency in Internal Control:** Exists when the design or operation of a control does not allow management or employees to prevent or detect misstatements on a timely basis.
- **Material Weakness:** A deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

#### **Identification and Assessment**

- **During the Engagement:** Be vigilant for signs of deficiencies as part of the audit process.
- **Risk Assessment:** Use a risk-based approach to identify areas where internal controls may be lacking.
- **Materiality:** Assess whether deficiencies could result in material misstatements.

## **Communicating with Management and Those Charged with Governance**

- **When to Communicate:** Deficiencies should be communicated in writing to management and those charged with governance as soon as they are identified.
- **Material Weaknesses:** These must be communicated in writing to those charged with governance before the audit report is issued. Management should also be informed promptly.

### **Content of Communication**

- **Description of Deficiency:** Clearly describe the nature of the deficiency or material weakness and the context within which it occurs.
- **Implications:** Explain the potential effects of the deficiency on financial reporting and the organization's operations.
- **References:** Provide references to the relevant auditing standards or regulatory guidance.
- **Suggestions for Improvement:** Offer recommendations for correcting the deficiency or strengthening the internal control.

### **Drafting the Communication**

- **Formal Letter or Report:** Prepare a structured document, either a letter or a report, to communicate the findings.
- **Clear Language:** Avoid technical jargon and explain terms when needed.
- **Prioritization:** Emphasize the importance of addressing material weaknesses immediately.

## Timing of Communications

- **Deficiencies Identified During the Audit:** Communicate these in writing upon identification and assessment, without waiting for the conclusion of the audit.
- **Material Weaknesses:** These must be communicated in writing as soon as the determination is made that a deficiency or combination of deficiencies constitute a material weakness.

## Follow-up

- **Management's Response:** Document management's response to the identified deficiencies or material weaknesses.
- **Action Plan:** Encourage management to provide a timetable for corrective action.
- **Subsequent Engagement Considerations:** Assess the implementation of corrective actions in subsequent engagements.

## Documentation for the Auditor

- **Record of Communication:** The auditor should retain a copy of all communications regarding internal control deficiencies and material weaknesses.
- **Work Papers:** Document the auditor's basis for determining the severity of each deficiency identified.

*Application: Prepare written communication materials for use in communicating identified internal control deficiencies and material weaknesses for an engagement to those charged with governance and management.*

**Example Outline for Written Communication:**

*[Your Firm's Letterhead]*

*[Date]*

*[Recipient Name]*

*[Title]*

*[Organization]*

*Subject: Communication of Internal Control Related Matters Identified in Audit*

*Dear [Recipient Name],*

*We have completed our audit of [Organization's] financial statements as of [date] and for the year then ended, and have identified certain matters relating to the organization's internal control over financial reporting that we wish to bring to your attention.*

**1. Introduction**

- Purpose of this communication*
- Scope of the audit*

**2. Description of Identified Deficiencies**

- [Deficiency #1]: [Description and context]*

- *[Deficiency #2]: [Description and context]*
- *[...]*

### **3. Severity Assessment**

- *Identification of material weaknesses*
- *Risk implications of the identified deficiencies*

### **4. Recommendations**

- *Suggested actions for [Deficiency #1]*
- *Suggested actions for [Deficiency #2]*
- *[...]*

### **5. Conclusion**

- *The importance of internal control and management's role*
- *Offer to discuss the contents of this letter in detail*

*We would like to discuss these matters with you at your earliest convenience to help you understand the implications and to determine how best to address these deficiencies.*

*Please contact us at [your contact information] to arrange a meeting.*

*Sincerely,*

*[Your Name]*

*[Your Title]*

*Enclosures: [Any appendices or additional documents]*

## **G. Audit and Assurance Quality**

*Remembering and Understanding: Identify a CPA firm's responsibilities for its accounting and auditing practice's engagement quality.*

### **Understanding a CPA Firm's Engagement Quality Responsibilities**

#### **Introduction to Engagement Quality**

The AICPA's Statement on Quality Control Standards (SQCSs) provides a framework for a CPA firm's responsibilities for its system of quality control.

#### **Leadership Responsibilities**

- **Tone at the Top:** The firm should demonstrate a commitment to quality at all levels, starting with leadership.
- **Responsibility Assignment:** Assign qualified individuals to assume responsibility for the firm's quality control system.

#### **Engagement Performance**

- **Standards Compliance:** Ensure that engagements are performed in accordance with professional standards and regulatory requirements.
- **Supervision and Review:** Implement a process for appropriate supervision and timely reviews at all levels of the engagement team.

## **Human Resources**

- **Personnel Management:** Recruit, hire, develop, and retain competent personnel.
- **Training and Competence:** Provide continuing professional education and training to all staff.
- **Performance Evaluation:** Establish fair and transparent policies for evaluating the performance of personnel.

## **Acceptance and Continuance of Client Relationships and Engagements**

- **Client Screening:** Establish policies for the acceptance and continuance of client relationships and engagements that align with the firm's risk tolerance.
- **Engagement Continuance:** Regularly reassess ongoing engagements and the clients' integrity.

## **Monitoring**

- **Ongoing and Periodic Assessments:** Implement monitoring procedures to provide reasonable assurance that policies and procedures relating to quality control are relevant, adequate, and operating effectively.
- **Remediation:** Address and rectify any identified deficiencies in the firm's quality control system.

## **Documentation and Retention**

- **Policies and Procedures Documentation:** Maintain documentation that provides evidence of the operation of each element of quality control.



- Retention Policy: Comply with professional standards and legal requirements concerning the retention of engagement documentation and quality control records.

## **Ethical Requirements**

- Code of Conduct: Adhere to the profession's code of conduct, emphasizing independence, integrity, and objectivity.
- Conflict of Interest: Establish a process to identify and manage conflicts of interest.

## **Engagement Quality Control Review (EQCR)**

- Objective Evaluation: Perform an EQCR to provide an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report.
- Reviewer Qualifications: The reviewer should be a professional who has not been part of the engagement team and possesses the necessary experience and authority.

## **Reporting and Communication**

- Internal Reporting: Report periodically to the firm's personnel on the quality control system's effectiveness, including any deficiencies and corrective actions.
- External Communication: Communicate with external parties, such as regulators or external quality inspectors, as required.

*Remembering and Understanding: Explain procedures and responsibilities for managing engagement quality.*

## **Procedures for Managing Engagement Quality**

### **1. Quality Management System Design**

- Develop a comprehensive quality management system tailored to the firm's size, nature, and complexity of the engagements.
- The system should cover all aspects of the engagement lifecycle, from client acceptance to engagement completion.

### **2. Assignment of Responsibilities**

- Assign quality management responsibilities to specific individuals or committees within the firm.
- Leadership must demonstrate a commitment to quality and allocate sufficient resources to maintain it.

### **3. Engagement Team Composition**

- Assemble engagement teams with the appropriate competence and capabilities.
- Ensure that team members maintain independence in both mind and appearance.

### **4. Engagement Performance**

- Adhere to the relevant auditing and attestation standards for each engagement.
- Supervise engagement teams and review work performed at relevant stages.

## **5. Monitoring**

- Regularly monitor compliance with both internal quality management policies and external professional standards.
- Address any deficiencies identified during the monitoring process.

## **6. Engagement Quality Reviews (EQR)**

- For higher-risk or complex engagements, an EQR should be performed by a professional with sufficient and appropriate experience and authority.
- The EQR should evaluate significant judgments made by the team and review key reports and documentation.

## **7. Documentation**

- Document all quality management processes and retain evidence of the monitoring and review work performed.
- Documentation should be sufficient to demonstrate compliance with the relevant standards and regulations.

## **8. Continuous Improvement**

- Assess the effectiveness of the quality management system regularly and make necessary improvements.
- Stay informed about changes in the auditing profession, including new standards and emerging risks.

# **Responsibilities for Managing Engagement Quality**

## **1. Firm Leadership**

- Ensure that the firm promotes a culture that recognizes and reinforces the importance of quality in every audit engagement.
- Take ultimate responsibility for the firm's system of quality management.

## **2. Quality Management Leader**

- Often a specific role or individual is designated to lead the firm's quality management efforts.
- This role includes setting policies, monitoring their application, and implementing improvements.

## **3. Engagement Partners**

- Take responsibility for the overall quality on each audit engagement.
- Ensure the engagement is appropriately resourced and supervised.

## **4. Engagement Quality Reviewers**

- Provide an objective evaluation of the significant judgments made by the engagement team.
- Confirm that the conclusions reached are supported by the audit evidence obtained.

## **5. Engagement Team Members**

- Maintain ethical principles, including independence and objectivity.
- Execute the audit in accordance with professional standards and the firm's policies.

## **6. Professional Development and Training**

The firm is responsible for providing training to ensure that personnel have the necessary knowledge and skills.

## **7. Human Resources**

Oversee recruitment, performance evaluations, and career development processes to maintain a workforce capable of achieving quality in engagements.

## **8. IT and Other Resources**

Ensure that engagement teams have access to appropriate technological tools and resources for effective audit performance.