Chapter 25

Other Assurance Services

■ **Concept Checks**

P. 807

1. Preparation is defined in SSARS as a service where the CPA is engaged by the client to prepare or assist in preparing financial statements, but the CPA does not provide any assurance on the financial statements or issue a report, even if the financial statements are expected to be used by, or provided to, a third party.

   Compilation is defined in SSARS as a service, the objective of which is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework.

   Review is defined by SSARS as a service, the objective of which is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. In a review engagement, the accountant should accumulate review evidence to obtain a limited level of assurance.

   There is no level of assurance provided in a preparation or compilation engagement. Reviews provide limited assurance, but considerably less than a typical audit.

2. The following types of procedures are emphasized for review services:

   - Obtain agreement on engagement terms with management or those charged with governance. This is generally in the form of an engagement letter or other suitable form of written agreement.
   - Obtain knowledge of the accounting principles and practices of the client's industry. The level of knowledge for reviews should be somewhat higher than that for a compilation.
   - Obtain knowledge of the client. The information should be about the nature of the client's business transactions, its accounting records and employees, and the basis, form, and content of the financial statements. The level of knowledge should be higher than that for compilation.
   - Make inquiries of management. The objective of these inquiries is to determine whether the financial statements are fairly presented,

Concept Check, P. 807 (continued)

assuming that management does not intend to deceive the accountant. Inquiry is the most important of the review procedures. The following are illustrative inquiries:

- Inquire as to the accounting standards framework used and the company's procedures for recording, classifying, and summarizing transactions, and disclosing information in the statements.
- Inquire as to whether unusual or significant transactions have occurred during the year, including important actions taken at meetings of stockholders and the board of directors.
- Inquire of persons having responsibility for financial and accounting matters whether the financial statements have been prepared in conformity with accounting standards.
- Inquire as to whether they have knowledge of an actual or suspected fraud, communications from regulatory agencies, subsequent events, or actions taken by those charged with governance.

■ Perform analytical procedures. The analytical procedures are meant to identify relationships and individual items that appear to be unusual. The appropriate analytical procedures are no different from the ones already studied in Chapters 7 and 8 and in those chapters dealing with tests of details of balances.

■ Read the financial statements. The accountant should read the financial statements to determine whether they conform with the financial reporting framework.

■ Reconcile the financial statements to the underlying accounting records. The accountant should obtain evidence that the financial statements agree or reconcile with the accounting records.

■ Obtain a letter of representation. The accountant is required to obtain a letter of representation from members of management who are knowledgeable about financial matters.

■ Prepare documentation. The accountant should prepare documentation of procedures performed, sources of evidence obtained, and conclusions reached.

P. 817

1. Attestation standards provide a general framework for and set reasonable boundaries around the attestation function. They provide guidance to AICPA standard-setting bodies for establishing detailed standards and interpretations of standards for specific types of services. They also provide practitioners useful guidance in performing new and evolving attestation services where no specific guidance exists.

Concept Check, P. 817 (continued)

The attestation standards, therefore, provide a conceptual framework for various types of services. Auditing standards do the same thing for the conduct of the ordinary audit of financial statements prepared in accordance with accounting standards.

2. An SOC 1 report, *Report on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting,* is intended to meet the needs of entities (known as user entities) that use service organizations and their auditors, who are responsible for understanding internal controls over financial reporting at service organizations. SOC 1 reports are used to plan and perform audits of the user entity's financial statements by their auditors, who are referred to as user auditors. There are two types of reports on controls at the service organization relevant to user entities' internal control over financial reporting:

    1. Report on management's description of a service organization's system and the suitability of the design of controls (referred to as a Type 1 report).
    2. Report on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls (referred to as a Type 2 report).

    An SOC 2 report, *Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*, is intended to meet the needs of a broad range of users who need information and assurance about controls at a service organization that affect the security, availability, and processing integrity of the systems the service organization uses to process users' data and the confidentiality and privacy of the information processed by these systems. For example, customers of a service organization may seek an SOC 2 report as part of their vendor risk management considerations. Similar to SOC 1 reports, there are two types of reports (Type 1 and Type 2). Use of these reports is generally restricted to specified parties, such as management of user entities, customers of the service organizations, regulators, suppliers, and business partners.

    An SOC 3 report, *Trust Services Report for Service Organizations*, is similar to an SOC 2 report except that the SOC 3 report is intended for wide distribution to current or potential users of the service organization. SOC 3 reports are prepared using the *Trust Services* principles and criteria shown in Table 25-2. While the distribution of an SOC 2 report is generally restricted, an SOC 3 report is a general-use report, which allows the service organization to share the report to current or prospective customers or to use it as a marketing tool demonstrating that they have appropriate controls in place to mitigate risks, such as those related to security or privacy.

■ Review Questions

25-1 Levels of assurance represent the degree of certainty the practitioner has attained, and wishes to convey, that the conclusions stated in his or her report are correct.

Audits of historical financial statements prepared in accordance with accounting standards are one type of examination. They are governed by auditing standards. An audit results in a conclusion that is in a positive form. In this type of report, the practitioner makes a direct statement as to whether the presentation of the assertions, taken as a whole, conforms to the applicable criteria. The level of assurance is high.

In a review, the practitioner provides a conclusion in the form of a negative assurance. In this form, the practitioner's report states whether any information came to the practitioner's attention to indicate that the assertions are not presented in all material respects in conformity with the applicable criteria. The level of assurance is limited.

A compilation is defined in SSARS as presenting, in the form of financial statements, information that is the representation of management *without undertaking to express any assurance* on the statements. A preparation engagement is defined in SSARS as a service where the CPA is engaged by the client to prepare or assist in preparing financial statements, but the CPA does not provide any assurance on the financial statements or issue a report, even if the financial statements are expected to be used by, or provided to, a third party.

25-2 A negative assurance states, along with factual statements, that nothing came to the accountant's attention that would lead the accountant to believe that the financial statements were not prepared in accordance with accounting standards. The reason for including such a statement in a review report is to provide financial statement users with some level of assurance that the financial statements are fairly stated. The level of assurance is less than that for an audit of historical financial statements, but more than the "no assurance" provided for a compilation.

25-3 One of three forms of compilation can be provided to clients:

- *Compilation With Full Disclosure* Compilation of this type requires disclosures in accordance with accounting standards, the same as for audited statements.
- *Compilation That Omits Substantially All Disclosures* This type of compilation is acceptable if *the report indicates the lack of disclosures* and the absence of disclosures is not, to the CPA's knowledge, undertaken with the intent to mislead users.
- *Compilation Without Independence* A CPA firm can issue a compilation report even if it is not independent with respect to the client, as defined by the *Code of Professional Conduct*. However, the CPA firm must state its lack of independence in the report.

25-4 The following are required by SSARS for compilation engagements. The preparer of the statements must:

- Establish an understanding with the client in a written engagement letter about the objectives of the nature of the engagement.
- Possess knowledge of the accounting principles and practices of the client's industry.
- Know the client, the nature of its business transactions, accounting records and employees, and the basis, form, and content of the financial statements.
- Make inquiries to determine whether the client's information is satisfactory.
- Read the compiled financial statements and be alert for any obvious omissions or errors in arithmetic and generally accepted accounting principles.
- Request management to provide additional or corrected information if the accountant becomes aware that the records, documents, explanations, or other information, including significant judgments by management is complete, inaccurate, or otherwise unsatisfactory.
- Disclose in the report any omissions or departures from accounting standards of which the accountant is aware. This requirement does not apply to a compilation that omits substantially all disclosures.
- Prepare documentation to provide a clear understanding of the work performed and any findings or issues that are significant.
- Request management to revise the financial statements, if the accountant becomes aware of needed revisions to the financial statements required for those statements to be in accordance with the applicable financial reporting framework.

25-5 For a compilation, the accountant does not have to make inquiries or perform other procedures to verify information supplied by the entity beyond those identified in the answer to Review Question 25-4. But if the accountant becomes aware that the statements are not fairly presented, he or she should obtain additional information. If the client refuses to provide the information, the accountant should withdraw from the compilation engagement.

25-6 Preparation is defined in SSARS as a service where the CPA is engaged by the client to prepare or assist in preparing financial statements, but the CPA does not provide any assurance on the financial statements or issue a report, even if the financial statements are expected to be used by, or provided to, a third party. Similarly, in a compilation the CPA is engaged to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with the applicable financial reporting framework. The key difference is that in a compilation the CPA must

25-6 (continued)

issue a compilation report and each page of the financial statements state "See accountant's compilation report." In a preparation service, the CPA does not issue a report, but the CPA includes a statement on each page of the financial statements that indicates, at a minimum, "no assurance is provided" on the financial statements.

25-7 For review services, if a client fails to follow applicable accounting standards, a modification of the report is needed. The accountant is not required to determine the *effect of a departure* if management has not done so, but that fact must also be disclosed in the report. For example, the use of replacement cost rather than FIFO for inventory valuation would have to be disclosed, but the effect of the departure on net earnings does not require disclosure.

25-8 Compilations and reviews under SSARS can only be issued for nonpublic companies for which an audit has not been performed. They may be for monthly, quarterly, or annual statements.

Reviews are issued on quarterly information of publicly held companies as a part of the client's reporting requirements to the SEC and are subject to PCAOB standards. Although there are some minor differences in some of the review procedures performed and in the wording on a review report for a nonpublic company and a public company review report, they are substantively the same.

25-9 The review procedures are essentially the same for public company and SSARS reviews. Some additional procedures are required for public company reviews that are beyond the scope of SSARS as follows:

- The level of knowledge the accountant has about the client's internal control is likely to be higher for public company reviews. Because an annual audit is done for public companies that have an interim review, the accountant must also obtain sufficient information about the client's internal control for both annual and interim financial information.
- The auditor's knowledge of the results of the audit procedures performed during the annual audit will affect the scope of the procedures performed during the review of interim financial information.
- The accountant will also have a good idea whether the quarterly statements were accurate after the annual audit is complete. This information will be useful in determining the review procedures in subsequent years.
- Under SSARS, the auditor makes inquiries about actions of directors and stockholder meetings; for public companies, the auditor reads the minutes of those meetings.

25-10 In response to a request to provide assurance on information contained in New Dominion's Corporate Sustainability Report, the accountant would conduct the engagement in accordance with Statements on Standards for Attestation Engagements (SSAEs). The accountant would most likely be engaged to conduct an examination level attestation engagement whereby the accountant would issue an opinion on the presentation of management's assertions about compliance with specific sustainability criteria.

25-11 The five *Trust Services* principles include the following:

1. *Security* – Security practices ensuring that the system is protected against authorized access (both physical and logical).
2. *Availability* – Availability practices, ensuring that the system is available for operation and use as committed or agreed.
3. *Processing Integrity* – Processing integrity, ensuring that system processing is complete, accurate, timely, and authorized.
4. *Online Privacy* – Online privacy practices, ensuring that personal information obtained as a result of e-commerce is collected, used, disclosed, and retained as committed or agreed.
5. *Confidentiality* – Confidentiality practices, ensuring that information designated as confidential is protected as committed or agreed.

25-12 In a Type 1 SOC 1 report, the accountant provides an opinion about the fairness of the description of the service organization's system and opinion about the suitability of the design of the controls in that system. In a Type 2 report, the accountant provides the opinions contained in a Type 1 report, plus an opinion on the operating effectiveness of controls at the service organization.

25-13 The service organization would engage the accountant to issue an SOC 3 report, *Trust Services Report for Service Organizations*. The SOC 3 report is intended for wide distribution to current or potential users of the service organization. SOC 3 reports are prepared using the *Trust Services* principles and criteria shown in Table 25-2. Because an SOC 3 report is a general-use report, the service organization is allowed to share the report to current or prospective customers and use it as a marketing tool to demonstrate they have appropriate controls in place to mitigate risks, such as those related to security or privacy.

25-14 One option would be for you to visit the service organization to obtain evidence about the design and operating effectiveness of internal controls at the service organization. However, a more efficient option may be for the service organization to engage its auditor to provide a Type 1 report that provides an opinion about the fairness of the description of the service organization's system and opinion about the suitability of the design of the controls in that system. Or, the service organization may engage its auditor to provide a Type 2 report that provides the opinions contained in a Type 1 report, plus an opinion on the operating effectiveness of controls at the service organization.

25-15 A *prospective financial statement* is a predicted or expected financial statement in some future period or at some future date. There are two general types of prospective financial statements: forecasts and projections. A *forecast* is a prospective financial statement that presents an entity's expected financial position, results of operations, and cash flows for future periods, to the best of the responsible party's knowledge and belief. A *projection* is a prospective financial statement that presents an entity's financial position, results of operations, and cash flows, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions.

An examination of prospective financial statements involves:

- Evaluating the preparation of the prospective financial statements.
- Evaluating the support underlying assumptions.
- Evaluating the presentation of the prospective financial statements for conformity with AICPA presentation guidelines.
- Issuing an examination report.

25-16 It would be appropriate for Germany to provide a report to Northern State Bank on all of the conditions except the competency of management. Reports on the working capital ratio, dividends paid on preferred stock, and aging of accounts receivable are factual matters within a normal auditor's competence. Reporting on the competence of management is highly subjective and should not ordinarily be in a debt compliance letter.

■ Multiple Choice Questions From CPA Examinations

25-17 a. (2) b. (2) c. (1)

25-18 a. (1) b. (4)

25-19 a. (1) b. (1)

■ Multiple Choice Questions From Becker CPA Exam Review

25-20 a. (1) b. (4) c. (4)

■ Discussion Questions and Problems

25-21 The accountant is responsible for the care in the preparation of compiled financial statements. The accountant must perform all the steps identified in the answer in Review Question 25-4 with due care. The report must also be properly prepared and reflect the findings of the accountant.

Users other than management are not prohibited from using compiled financial statements. They can expect the accountant to meet the standards set by the profession.

25-21 (continued)

The courts have not established the responsibilities of accountants for compilations. Presumably, the responsibilities should be far less than for audits and somewhat less than for reviews. Responsibilities exist, but the level has yet to be finalized.

25-22 a. The primary procedures performed in a review engagement consist of performing analytical procedures and inquiries of management. But, in addition to those procedures, the accountant should also perform the following:

- Obtain knowledge of the accounting principles and practices of the client's industry.
- Obtain knowledge of the client's business
- Obtain a letter of representation
- Perform additional procedures if the accountant becomes concerned that information is incorrect, incomplete, or otherwise unsatisfactory.
- Read the financial statements.
- Prepare documentation of procedures performed, evidence examined, and conclusions reached.
- Issue the review report.

b.

1. Inquire about the nature of repairs made to determine if any represent expenses that should be capitalized. Ask about whether any of the related property, plant, and equipment should be adjusted to reflect permanent impairment and inquire if any equipment that is currently included in the financial statements has been disposed of during the year.
2. Inquire about whether management has documentation in the contract of the real estate taxes not being the responsibility of the client until next year and ask to review that contract. Perhaps examine any public records of tax obligations for the county or municipality to determine the status of outstanding taxes due.
3. Ask management to provide invoices from most recent purchases of pipes for construction and estimate the inventory values based on the most recent prices to determine the impact of changes in market conditions on the ending inventory balance.
4. Calculate accounts receivable turnover and days to collect receivables and compare trends to prior years to determine whether collections are slowing. Analyze aging categories of accounts receivable relative to prior years to evaluate whether receivables are older.
5. Make inquiries of the client's legal counsel to obtain their views of the likely outcome of the lawsuit.

25-23

PROCEDURE	a. REQUIRED ON A COMPILATION ENGAGEMENT	b. REQUIRED ON A REVIEW ENGAGEMENT
1.	X	X
2.	X	X
3.	X	X
4.		X
5.	X	X
6.		
7.		
8.		X
9.	X	X
10.		X

X = Required procedure

25-24 a. In addition to the inquiries listed, the accountant must understand the client's business to facilitate evaluating whether the statements are reasonable. Analytical procedures must also be performed. It may also be appropriate to inquire about such things as the possibility of unbilled sales, authorization procedures for sales, whether the accounts receivable control account has been reconciled with the master file records, and the possible inclusion of consignment shipments as sales.

b. In reviews, no procedures such as tests of controls, substantive tests of transactions, cutoff tests, or confirmation requests are done. The only things that are done are inquiries and analytical tests. An examination of the procedures for sales and receivables discussed in Chapters 14 and 16 shows that there is considerable difference between an audit and those review procedures listed in this problem.

c. Inquiries would ordinarily be made of the chief financial officer in a small or large business. Ordinarily the chief financial officer in a small business is the owner, but it may also be a controller or vice-president.

25-24 (continued)

d. Additional procedures should be performed when the accountant believes, based on the information obtained through inquiry and analytical procedures, that the financial statements may be materially misstated. Examples where this could be the case are:

- A material increase in the gross margin percent
- A material decrease in allowance for uncollectible accounts divided by accounts receivable
- A statement by a bookkeeper that leads the accountant to believe the client's personnel do not fully understand correct sales cutoff procedures

e. The achieved level of assurance for audits is ordinarily much higher than for reviews. The differences in the procedures identified in this problem and those studied in Chapters 14 and 16 are significant and result in large differences in the achieved levels of assurance.

25-25 The following changes would need to be made to Jennifer's draft of the review report:

- A report title should be added:

  "Report of Independent Registered Public Accounting Firm"

Changes to Introductory Paragraph:

- The word "examined" in the first sentence should be replaced with "reviewed" since this is a review level engagement.
- The first sentence also needs to include a reference to the Statement of Retained Earnings and Statement of Cash Flows that also would have been reviewed in the engagement.
- The financial statements reviewed would include those prepared for the three-month period and nine-month period ending at the end of the third quarter. The first sentence needs to reference both the three-month and nine-month financial statements.
- The second and third sentences of this paragraph should be moved to the next paragraph; however, the phrase "testing internal controls over financial reporting" should be deleted from the report given a review does not involve testing of internal controls.

Changes to Middle Paragraph:

The review would be conducted in accordance with PCAOB standards, not the SSARS standards issued by the AICPA. Thus, the opening sentence should be modified to reference the correct standards.

25-25 (continued)

- The second sentence needs to be deleted from the report.
- As noted in the changes affecting the introductory paragraph, a sentence needs to be added to the middle paragraph to describe that a review consists primarily of applying analytical procedures and inquiries and another sentence needs to be added that notes that a review is substantially less in scope than an audit in accordance with PCAOB standards.
- A final sentence should be added at the end of the middle paragraph that explicitly states that the accountant is not expressing an opinion on the financial statements.

Changes to Final Paragraph:

- The accountant does not have a basis for issuing an opinion on the financial statements. Thus, the phrase "it is our opinion" should be replaced with "we are not aware of any material modifications that should be made to the accompanying interim financial statements."
- The financial reporting framework used by management to present the financial statements would be generally accepted accounting principles (GAAP) in the U.S. Because those standards are not issued by the Securities and Exchange Commission, the reference to the SEC should be removed.

Note: The report would include the audit firm's signature and be dated as of the end of the completion of the review procedures.

25-26 Note: The company does not archive its Sustainability Reports on its Web site. While there are other sources for locating corporate sustainability reports, we suggest you have students locate the most recent Sustainability Report posted at the Home Depot Web Site under the "Corporate Responsibility" tab. The topics addressed in this problem are likely to continue to be areas of focus in future reports. You may want to adjust the requirement in part a. to have them to simply identify the major areas of focus of the sustainability program, such as energy and water usage, carbon emissions, etc. This solution is based on information posted on the Home Depot Web site about Milestones for Home Depot's sustainability efforts in 2014:

25-26 (continued)

a. The Sustainability Integration System assigns leaders to each of these areas of focus: Energy, Water, Information Technology, Supply Chain, Stores, and Packaging. Collectively, they are working to make structured improvements related to energy and water usage, carbon emissions, sustainable operations, sustainable product assortment, and supply chain impact. The company is focused on the biggest impacts like energy use, rainwater capturing, new store construction impact reduction, and recycled products (they recycle batteries, CFL bulbs, and cardboard). Note: In 2015, the company no longer uses the term "Sustainable Integration System." However, they continue to be focused on the same areas of interest.

b. During 2014, the company recycled 725,000 pounds of CFL bulbs, 940,000 pounds of rechargeable batteries, and over 107,000 lead acid batteries for customers. They also reclaimed rainwater in 150 Garden Centers, which resulted in 500,000 gallons of water saved per year per store.

c. Users who would like to rely on many of the claims included by management in the Home Depot sustainability report may desire some assurance that the assertions made are accurate and reliable. For example, the company reports a number of milestones they have accomplished in their sustainability efforts, (such as those noted in part b.) that users of that information may want an objective party to verify. To have confidence in the reported assertions, users may seek an independent third party to provide some level of assurance about the accuracy and reliability of those assertions.

d. Because some of the other assertions made by management in their report are based on scientific data, an independent accountant may not have the competence and ability to examine evidence that would be used to provide a basis for an opinion about the accuracy and reliability of the assertion. The reduction in Kilowatt usage and the expansion of their garden line to carry over 300 total organic products given those assertions may be easily measured. For example, Kilowatt usage may be measured based on information provided by third-party energy providers (e.g., power company billings). However, assertions related to the company's efforts that led to a reduction of 3.6 million tons of Green House Gas (GHG) emissions from purchases made by their consumers may be difficult to verify

25-26 (continued)

given that accountants may not have the expertise to measure and evaluate that assertion. Some of the assertions in the report are too general to be measurable. Thus, accountants or other independent parties would have difficulty providing assurance about those assertions. For example, the assertion that Home Depot "saved customers over $630 million in energy costs through energy saving products" may be difficult to verify.

25-27 a. When clients outsource some or all of their IT needs to an independent computer service organization rather than maintain an internal IT function or data center, their auditors may face difficulty when obtaining an understanding of the client's internal control over financial reporting because many of the controls reside at the service organization, and the auditor cannot assume that the controls are adequate since they are provided by an independent IT provider. It has become increasingly common for the service center to engage a CPA firm to obtain an understanding and test internal controls of the service organization and issue a report for use by all customers and their independent auditors.

b. When clients outsource some or all of their IT needs to an independent computer service organization, their auditors could examine a Type 1 SOC 1 report on management's description of a service organization's system and the suitability of the design of controls to obtain information about the design of controls at the service organization. In a Type 1 report, the service auditor expresses an opinion about the fairness of the description of the service organization's system and an opinion about the suitability of the design of controls in that system.

The service auditor obtains and reads the system description prepared by the organization's management and assesses whether the description is fairly presented. In making that assessment, the service auditor evaluates whether management used suitable criteria in preparing and presenting the service organization's system description. The service auditor also performs procedures to obtain sufficient appropriate evidence to obtain reasonable assurance about the suitability of the design of controls. In making that determination, the service auditor evaluates whether controls have been designed to address risks threatening the achievement of control objectives and whether those controls, if operating as described, provide reasonable assurance that those risks would not prevent achievement of control objectives.

25-27 (continued)

c. When clients outsource some or all of their IT needs to an independent computer service organization, their auditors could examine a Type 2 SOC 1 report on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls. In a Type 2 engagement, the service auditor performs tests of the operating effectiveness of the controls at the service organization, in addition to procedures performed in the Type 1 engagement. The service auditor's Type 2 report contains the two opinions about the description and suitability of the design of controls that are provided in a Type 1 report, plus an additional opinion about the operating effectiveness of controls throughout the period.

d. SOC 1 reports address internal controls over financial reporting. But, in this situation, management of a service organization that processes quality control reports related to the user entity's manufacturing processes could engage their auditor to provide an SOC 2 report, *Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy.* A SOC 2 report is intended to meet the needs of a broad range of users who need information and assurance about controls at a service organization that affect the security, availability, and processing integrity of the systems the service organization uses to process users' data and the confidentiality and privacy of the information processed by these systems.

25-28 a. It would be acceptable to undertake the engagement only if all of the following conditions exist:

- The accountant has sufficient competence to properly complete an examination of the forecasted financial statements.
- The client is willing to take responsibility for preparation (with the accountant's assistance) of the forecast in accordance with guidelines, established by the AICPA in *Statements on Standards for Accountant's Services on Prospective Financial Statements*.
- The accountant believes a reasonably accurate forecast is practicable in the circumstances.
- The client understands and agrees to the examination procedures and reporting requirements the accountant must comply with.

25-28 (continued)

b. If Monson believes the accountant can issue an opinion about the achievability of the forecast, but later finds that such an opinion cannot be given, Monson is likely to be unhappy. The result would be a loss of fee, loss of a client for other services, and perhaps even a lawsuit. Similarly, Monson must understand his responsibilities concerning the forecast of the assumptions and other aspects of the report, again to avoid a misunderstanding later.

c. The primary information the CPA firm will need to help in completing the forecast are the following:

- Audited financial statements for the past several years. (Easily available because Monson is an audit client.)
- Information about the economic conditions of the industry. The CPA firm will likely need knowledge beyond that required for performing the audits.
- Information about the offer he has made for the new business and the offer he has received for the existing assets. Because the financial statements will be a forecast, and not a projection, it is necessary to determine that there is a reasonable likelihood of the transaction being completed and the forecasted result, assuming both transactions are finalized.

d. The report will be a report on a forecast and will include the following components:

- An identification of the prospective financial statements presented.
- A statement that the examination of the prospective financial statements was made in accordance with AICPA standards and a brief description of the nature of such examination.
- The accountant's opinion that the prospective financial statements are presented in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the forecast.
- A caveat that the prospective results may not be achieved.
- A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

25-29 a. *We have audited, in accordance with generally accepted auditing standards in the United States of America, the financial statements of Pollution Control Devices, Inc., which comprise the balance as of _________ and the related statements of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated ______.*

25-29 (continued)

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with any of the provisions of the indenture dated ________ with (lender) insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Company's noncompliance with the above-referenced provisions of the indenture insofar as they relate to accounting matters.

This report is intended solely for the information and use of the boards of directors and management of Pollution Control Devices, Inc., and (lender) and is not intended to be and should not be used by anyone other than these specified parties.

b. The supplemental report would have to state that the company was not in compliance with the provisions of the indenture because net earnings did not exceed dividends by at least $1,000,000.

c. The supplemental report would be the same as discussed in b. Assuming that a default in the provisions of the indenture results in the loan becoming due immediately, the auditor's report would have to include either an adverse or qualified opinion depending upon the materiality of the misstatement. Because the mortgage is for $4 million, which is material to the client, violation of the indenture and potential default cannot be dismissed as being immaterial.

d. Contingencies due to a lawsuit may affect the liabilities of the client that will affect the indenture provisions. The auditor will be unable to express an opinion in the debt compliance letter because of this uncertainty. This should be disclosed in the supplemental report.

25-30 a. Jones will probably have to conduct additional audit tests in order to report on these items individually. It will be necessary for Jones to accumulate additional evidence because the materiality of the individual items is much lower than for the overall financial statements. The additional evidence will enable the auditor to obtain a higher level of assurance regarding the items than is attained without expanding the audit procedures. The individual items have a lower level of materiality because their magnitude is less than the overall financial statements. Therefore, an amount that is not considered material to the financial statements as a whole may be material when applied to the three accounts being considered.

25-30 (continued)

b. The following additional tests are likely to be needed before the special report can be issued:

Sales

- Cutoff tests of sales may be expanded
- Depending upon the previous results, tests of controls and substantive tests of transactions for sales may be increased

Net fixed assets

- Examine physical existence of a sample of fixed assets
- Determine if fixed assets are still on the books but not being used
- Recalculate depreciation
- Increase vouching of additions in the current year

Inventory

- Increase the price test coverage of inventory value

It should be noted that the extent of these tests depends on the results attained in these areas in the audit, the amount of evidence gathered in the audit, and the client's internal controls. The audit procedures above are vague because of this and are intended to be illustrative of the type of procedures that should be considered. After-the-fact auditing has limitations in that some information cannot feasibly be recreated. For instance, the auditor cannot extend test counts of inventory in order to verify the quantity of inventory. In these cases the auditor must attempt to satisfy the objective by alternative methods.

c. To answer this question, students will need to access the AICPA auditing standards to find the specific reporting guidance. The following solution is based on Exhibit A - Illustration 4 contained in the Appendix of AU-C – 805, "Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement."

We have audited the schedules of sales, net fixed assets, and inventory valued at FIFO (as defined in the lease agreement dated _________ between (lessor) and Sarack Lumber Supply Co.) of Sarack Lumber Supply Co. for the year-ended ________.

Management is responsible for the preparation and fair presentation of these schedules in accordance with financial reporting provisions contained in the lease agreement between

25-30 (continued)

(lessor) and Sarack Lumber Supply Co. referred to above; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the schedule that is free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in these schedules. The procedures selected depend on the auditor's judgment, including the assessment of risks of material misstatements of the schedules, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentations of the schedules in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the schedule.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

In our opinion, the schedules of sales, net fixed assets, and inventory valued at FIFO present fairly, in all material respects, the sales, net fixed assets, and inventory valued at FIFO of Sarack Lumber Supply Co. for the year-ended _____, on the basis specified in the lease agreement referred to above.

We draw attention to Note X to the schedules, which describes the basis of accounting. The schedules were prepared by Sarack Lumber Supply Co. on the basis of the financial reporting provisions contained in the lease agreement referred to above, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to comply with the financial reporting provisions of the agreement referred to above. Our opinion is not modified with respect to this matter.

Our report is intended solely for the information and use of the boards of directors and management of Sarack Lumber Supply Co. and (lessor) and should not be used for any other purpose.