Contingent liability—a potential future obligation to an outside party for an unknown amount resulting from activities that have already taken place. Three conditions are required for a contingent liability to exist: 1) there is a potential future payment to an outside party that resulted from an existing condition; 2) there is uncertainty about the amount of the future payment and 3) the outcome will be resolved by some future event or events.

SFAS No. 5 discusses three levels of likelihood:

Probable—the future event or events are likely to occur
Reasonably possible—the chance that the future event or events will occur is more than remote but less than probable

Remote—the chance that the event will occur is slight

If a potential loss is probable and the amount can be reasonably estimated the loss should be accrued and indicated in the body of the financial statements. Disclosure in footnotes but no accrual is required if the amount of a probable loss cannot be reasonably estimated or if the loss is only reasonably possible. The footnote should describe the nature of the contingency to the extent it is known and the opinion of legal counsel or management as to the expected outcome.

Certain contingent liabilities are of considerable concern to the auditor:

--pending litigation
--income tax disputes
--product warranties
--notes receivable discounted
--guarantees
--unused balances in outstanding L/Cs
--standby L/Cs

The following are some audit procedures commonly used to search for contingent liabilities:

--inquire of management regarding the possibility of unrecorded contingencies

--review current and previous years’ internal revenue agent reports for income tax settlements

--review minutes of stockholder and B of D meetings

--analyze legal expenses and review invoices and statements from legal counsel for indications of contingent liabilities

--obtain a confirmation from all major attorneys performing legal services as to the status of pending litigation
--review existing work papers for any information that may indicate a contingency

--review L/Cs in force as of the balance sheet date

The standard letter of confirmation from the client’s attorney, which should be prepared on the client’s letterhead and signed by one of the company’s officers, should include the following:

--a list, prepared by management, of likely material unasserted litigation, claims, or assessments

--a list, prepared by management, of likely material unasserted claims and assessments

--a request that the attorney furnish information or comment about the progress of each listed claim or assessment, the legal action the client intends to take, the likelihood of an unfavorable outcome and an estimate of the range of loss
Review for Subsequent Events

Two types of subsequent events require consideration by management and evaluation by the auditor:

1—those that have a direct effect on the financial statements and require adjustment (Type I) such as the following when material:

--the declaration of bankruptcy due to deteriorating financial condition of a customer with outstanding A/R
--sale of investments at a price below recorded cost

2—those that have no direct effect on the financial statements but for which disclosure is advisable (Type II)

Events of this type provide evidence of conditions that did not exist at the balance sheet date but are so significant they require disclosure even though they require no adjustment.

--e.g., decline in the market value of securities held for temporary investment or resale or an uninsured loss of inventories as a result of fire
These tests include the following:

--inquire of management
--correspond with attorneys
--review internal statements prepared subsequent to the balance sheet date. Look at changes across year end and changes in the business relative to results for the same period in the year under audit
--review records prepared subsequent to the balance sheet date—journals and ledgers should be reviewed to determine the existence and nature of any transaction related to the current year
--examine minutes of stockholders & B of D meetings subsequent to the balance sheet date for subsequent events
--obtain a letter of representation
Final Evidence Accumulation

1—Final Analytical Procedures

Analytical procedures done during the completion of the audit are useful as a final review for material misstatements. It is common for a partner to do the analytical procedures during the final review.

2—Client Representation Letter

There are two purposes of the client letter of representation:

1—to impress upon management its responsibility for the assertions in the financial statements

It should be sufficiently detailed to serve as a reminder for management.

2—to document the responses from management to inquiries about various aspects of the audit
SAS 85 suggests many specific matters that should be included, when applicable, in a client representation letter. A few of these are:

--management’s acknowledgment of its responsibility for the fair presentation of the financial statements in conformity with GAAP

--availability of all financial records and data

--information concerning related-party transactions

--completeness and availability of all minutes of stockholder and B of D meetings

--disclosure of compensating balances or other arrangements involving restrictions on cash balances and disclosure of line-of-credit or similar arrangements
Evaluate Results

1—Does the evidence support the auditor’s opinion?

An important part of evaluating whether the financial statements are presented fairly is summarizing the errors uncovered in the audit. The trial balance should be adjusted for material errors.

Often there are a large number of immaterial errors discovered that are not adjusted at the time they are found. It is necessary to combine individually immaterial errors to evaluate whether the combined total is material.

If the auditor has sufficient evidence but it does not warrant a conclusion of fairly presented statements, the auditor has two choices:

1—statements must be revised
2—a qualified or adverse opinion must be issued
2—Are the disclosures in the financial statements adequate?

This includes a complete review of all footnotes. The auditor must be constantly alert for disclosure problems not just at the completion of the audit.

Many CPAs use a financial statement disclosure checklist. However, one cannot rely on a checklist to replace one’s knowledge of GAAP.
3—Working Paper Review

There are three main reasons why it is essential that the working papers be thoroughly reviewed by another member of the audit firm at the completion of the audit:

1—to evaluate the performance of inexperienced personnel

2—to make sure that the audit meets the CPA firm’s standard of performance

3—to counteract the bias that may enter into the auditor’s judgment